STATE BANKS
AND THE
FEDERAL RESERVE SYSTEM

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PREFACE

The federal reserve system is now almost fifteen years old. And yet, in many ways, it is still in its infancy. We have learned much from its experiences during the past decade. But that we have much more to learn is quite obvious. For example, there is at present widespread disagreement over what constitutes the proper functions of the federal reserve system. At the same time that its policies are drawing commendation from certain quarters, they are being vigorously criticised in others. This difference of opinion cannot be avoided; in fact it should be welcomed. Nothing reveals a public institution in its true light more than free and open discussion of its merits. But is it too much to ask of critics of the federal reserve system that they base their criticisms on facts rather than on imagination or prejudice, as they have frequently done in the past?

The advantages and disadvantages of membership in the federal reserve system have furnished a fertile field for controversy. There is still much ignorance or misunderstanding of the operations of the system on the part of bank directors and executives, to say nothing of the general public. Nowhere is this more clearly evident than in discussions on the value of membership in the system. The great majority of American banks will probably not join the federal reserve system, at least during this generation. While their membership is not essential to the success of the system, yet many of them would find it to their advantage to join. And the irony of the situation is that the very benefits for which the federal reserve system is responsible render any perceptible increase in membership in the near future highly improbable. For nonmembers

enjoy many of the advantages of membership indirectly, through their city correspondents.

In a study of this phase of the federal reserve system we are confronted with certain unpleasant facts. There are now one thousand fewer members of all kinds than in 1922. Over two hundred state banks and trust companies have withdrawn from membership. Nearly one thousand national and state bank members have closed their doors because of financial difficulties since 1920. Surely, there has been something wrong somewhere. Would not more stringent supervision have prevented the insolvency of a large part of the seven hundred national banks that failed during this period? It would seem so. But that is not the complete answer.

No answer could be satisfactory that did not recognize the dual character of our banking system. A severe tightening of banking standards in the federal reserve system would probably drive out a large number of present members, because they could, in many cases, operate under state laws much more profitably. Until the various states take appropriate measures to secure higher standards of banking ability and practices it is difficult for the federal reserve system to accomplish much more than it has already done in this respect.

In view of the fact that members of the system deserve special consideration, I believe it would be advisable to amend the Federal Reserve Act to permit special dividends on federal reserve bank stock from time to time as the earnings of the reserve banks make this possible. There is now no particular reason why all of the surplus earnings should be paid to the government. I believe this can be done without committing the federal reserve banks to a profit making policy. A plan such as that proposed by the New England bankers in 1923 seems highly feasible.

Even if membership in the federal reserve system does not increase during the next few years there is little ground

for discouragement. A larger proportion of all banks in the country belong to the system than ever before, and the members control over three-fourths of the country's commercial banking resources.

The writer of a book of this nature is constantly faced by the problem of keeping his material and facts up to date. I have wished many times that I could have written about an episode concerning which nothing more could be discovered. A chapter is no sooner finished than it stands in need of revision. I have completely revised various portions of this volume several times because of succeeding developments, and even now as it goes to press I find some of it already out of date. Take the chapter on branch banking, for example. Events have moved so swiftly in this field that by June 30, 1928 the total number of branches had grown to 3230. On that date, 169 national banks operated 941 branches; 186 state members operated 1220 branches; and 480 non-members controlled 1069 branches. Unfortunately, for the writer of contemporary economic history, economic changes occur so rapidly that the written record lags always far behind.

I have tried in this study to present an accurate description and discussion of the problems arising from state bank and trust company membership in the federal reserve system. Those to whom I am indebted for information and assistance are too numerous all to be mentioned here individually. May I take this opportunity of expressing my lasting gratitude to the officers of the federal reserve banks and the national and state bankers who gave me so unsparingly of their time and knowledge. I am especially grateful to Mr. Walter L. Eddy, Secretary of the Federal Reserve Board; Mr. C. A. Peple, Deputy Governor of the Federal Reserve Bank of Richmond; Mr. M. B. Wellborn, former governor of the Federal Reserve Bank of Atlanta; Mr. Wm. A. Heath, Federal Reserve Agent and Chairman of the Board of the Federal Reserve Bank of Chicago; Mr.

Wm. McC. Martin, now governor of the Federal Reserve Bank of St. Louis; and Mr. F. R. Jones of the County Bankers' Association of Georgia. They all showed the utmost courtesy and patience in replying to my requests for information.

To the Editors of the American Economic Review and the Journal of Political Economy I am indebted for permission to use material from articles which I have written and which have from time to time appeared in those journals.

My greatest debt of gratitude is to the Department of Economics of Princeton University. Mr. Edwin Walter Kemmerer, who first suggested the subject, was a constant source of inspiration and encouragement. Mr. Frank H. Dixon and Mr. George B. McClellan were at all times friendly and loyal counsellors. Mr. Frank A. Fetter, Mr. David A. McCabe, and Mr. Frank D. Graham all were kind enough to read the manuscript in its original form and made numerous suggestions. Mr Frank H. Knight, formerly of the University of Iowa, but now of the University of Chicago, read the manuscript as it approached its final form and offered many criticisms and suggestions for improvement. In Dean Chester A. Phillips of the University of Iowa I found an advisor and friend of inestimable worth. To these, at times severe but kindly critics, all that is really worthwhile in this book is due. With much that is in it I know they may not agree, but I have tried to describe the situation as it appeared to me. Miss Mary Elizabeth Dearborn was of great assistance in preparing the manuscript for the press. But without the constant patience, sympathy, and encouragement of my wife it could never have been written at all.

Seattle, March 6, 1929.

C. S. T.

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CHAPTER I

INTRODUCTION

The problem of creating a unified American banking system is as old as the Federal government itself. During a large part of American history we have suffered from a dual banking system. Each state has maintained and still maintains its own banking system in competition with banks chartered by the Federal government. The state banking institutions have generally operated under more liberal charters and more lenient laws. The result is that banks chartered by the Federal government have at times found it extremely difficult to meet this kind of competition. The problem is largely one of how to secure unified control.

It was hoped that the establishment of the federal reserve system in 1913 would settle the question. That it was a great step forward cannot be denied. However, only about one third of all the banks in the country are members of that system today.[1] There are no signs that a larger proportion will ever join. We must reconcile ourselves to the fact that the great majority of American banks will, for years to come, remain outside of the federal reserve system. That being true, the question of unified control has only been partially solved.

Were this all, we should still be justified in uttering a hymn of praise. But the banking history of the last eight years offers, instead, grounds for profound lamentations. Since 1920, approximately 5,000 American banks have

[1] On February 28, 1928, there were 26,155 banks in the United States. Of these 7,728 were national banks and 1,269 were state bank members of the federal reserve system. *Fed. Res. Bull.*, June, 1928, pp. 441–2.

closed their doors! But that is not the worst of it. Of these failures, 700 were national banks, and 200 were state bank members of the federal reserve system. One-sixth of all the banks in existence in this country in 1920 have suspended operations. The past eight years constitute one of the darkest chapters in all American banking history. Can any other country of recent times present a similar record of distinction?

One of the chief explanations for this disgraceful debacle may be found in the structure of our dual banking system. It is impossible to create a unified banking system of high standards and sound banking practices so long as each state tries to build up its own banking system at the expense of the national banks. To raise the requirements for national banks means a progressive decline in the number of such banks. Had it not been for the McFadden-Pepper Bank Act of 1927, which liberalized the National Bank Act, we should now probably be witnessing a wholesale exodus from the national system.

National banks must meet the competition of state banks. This is one of the most important facts in recent banking history. If this is borne in mind, the reason for many of the amendments to the Federal Reserve Act can be understood. It will also explain much of the dislike of the non-member banks for the federal reserve system. It will likewise explain why the provisions concerning state bank membership in the system have created such serious problems. It is impossible to give state banks special inducements to become members without creating widespread dissatisfaction on the part of the national banks which are compulsory members. And this is just what has happened. The problem, during the early years of the federal reserve system, was to encourage a large state bank membership and at the same time retain the good will of the national banks.

Much of the history of state banking institutions prior

to the Civil War is a record of unsound banking practices. The First Bank of the United States, chartered by the Federal government in 1791, experienced serious difficulties in its relations with the state banks and aroused their animosity. The Second Bank of the United States was engaged almost continually in violent controversies with these institutions over the redemption of state bank notes and the collection of balances owed the government.

There are many points of resemblance between the controversies arising from the attempts of the First and Second Banks of the United States to compel the irresponsible state banks to redeem their bank notes in specie, and those later arising out of the efforts of the federal reserve banks to force state banking institutions to remit at par on checks presented to them for payment. While the Banks of the United States were in existence, the state institutions were in some measure satisfactorily controlled. The charter of the First Bank of the United States expired in 1811. For the next five years the state banks ran riot, to be checked only by the Second Bank of the United States which came into existence in 1816. After Congress refused to renew its charter and the bank went out of existence in 1836, the state banks, again freed from any restraint, increased quickly in numbers and issued great quantities of notes which depreciated rapidly. Although one of the reasons for the creation of the national banks in 1863 was to establish a sound currency system it was not until the state bank notes were taxed out of existence in 1866 that the state banks were effectively controlled in this respect. After the enactment of this tax law it seemed for a time as if the state banking institutions would disappear and leave the field entirely to the national banks. The majority of the state banks gave up their state charters and joined the national system. But this movement soon ceased. The last forty years have witnessed a tremendous growth both in the number and power of the state banking institutions and now more than two-thirds

of the twenty-six thousand banking institutions in the United States operate under state charters. As a result, one of the most difficult problems which the Federal Reserve Board has had to face has been to determine what place the state banking institutions should occupy with respect to the federal reserve system.

The fact that American banking has always been characterized by a lack of unity made the path of the banking reform movement, which gathered strength after the panic of 1893, an extremely difficult one. Certain weaknesses became increasingly evident as time went on. These were a decentralization of reserves; inelasticity of circulating credit, due largely to rigid reserve requirements and the issue of national bank notes based on government bonds; a cumbersome and expensive check clearing and collection system; and undesirable relations between the banks and the United States Treasury.[2] What centralization of reserves there was, was unsound. The system under which a large part of the reserves of country banks was kept on deposit in banks in the larger cities is too well known to need extended comment here. When a crisis arose it was almost impossible for the country bank to withdraw these deposits. As to methods of relief there were wide differences of opinion. There were also differences of opinion as to what should be done with the state institutions in any plan of reform. Obviously, no reform would be satisfactory which left the state banks out of consideration.

The Federal Reserve Act was the culmination of a long agitation for banking reform. It made membership compulsory for national banks if they wished to retain their national charters, and gave permission to certain state in-

[2] For a full description of these defects and the way in which they were remedied by the federal reserve system see, Kemmerer, E. W., *The A B C of the Federal Reserve System*, 5th ed., Princeton University Press, Princeton, N. J., 1922. The National Monetary Commission listed these defects as lack of system, inelasticity of credit, periodic local congestion of funds, unequal territorial distribution of banking facilities, and little provision for foreign banking.

stitutions to join on various conditions. It is the object of this study to trace the steps by which and the conditions upon which the state institutions were made eligible for membership in the federal reserve system; to explain the unfavorable attitude of the state banking institutions toward the new system for so long after its adoption; to describe the changes which have been made in the Federal Reserve Act to make membership more attractive, and the way in which the state institutions responded; to investigate the attitude of these institutions during the late war; to consider whether their membership in the system is really desirable, necessary, or advantageous both for themselves and for the nation as a whole; and to point out what changes, if any, are still desirable in the law to meet the reasonable requirements of the state banks.

CHAPTER II

STATE BANKS AND BANKING REFORM

PRIOR to the Aldrich Plan of 1911 proposals for banking and currency reform almost entirely ignored the state banking institutions. The reason sometimes given for this omission was that although it was believed by many that they should be included it was difficult to decide what to do with them. On the other hand there were some authorities who vigorously opposed the inclusion of the state institutions, hoping perhaps that by leaving them out in the cold they would be forced to convert into national banks. Another reason lay in the fact that some advocates of banking reform felt that a plan affording relief to the large city national banks only would be sufficient since they could then give aid to others. Those holding this opinion were opposed to the creation of a large permanent system of reserve banks such as the Federal Reserve Act has brought into existence. Most of the proposed schemes, therefore, dealt with national banks only. The only way state banking institutions could share in the proposed reforms was to convert into national banks.

The National Bank Act, as originally enacted on February 25, 1863, provided in section 61 that any banking association or corporation lawfully in existence as a bank of circulation on January 1, 1863, organized in any state either under a special act of incorporation or a general banking law, might become a national association under the provisions of the act. An interesting provision in section 62 stated that any state bank owning United States Bonds to the amount of 50 per cent of its capital might transfer any amount of the bonds to the Treasurer of the

United States and receive from the Comptroller of the Currency circulating notes as provided in the act up to 80 per cent of the amount so transferred.[1]

The National Bank Act of 1863 was repealed the next year by the Act of June 3, 1864, but the majority of its provisions were reënacted by that law. It made similar but somewhat more extensive provisions for the converting of state banks into national banks.[2] The section allowing state banks to receive currency from the national government in exchange for their government bonds was not reënacted.[3]

The immediate results of the National Bank Act were discouraging. They were described by one writer as follows: [4]

> "The legislation on this subject up to this time did not bring about the voluntary nationalization of the state banks which was hoped for and was expected from it, but on the 3d of March, 1865, an act was passed which sounded the death knell of the state banks, in so far as they were dependent upon their circulation for their existence. A tax of 10% was laid upon the amount of notes of state banks which should be paid out by any bank or banking association after the 1st day of July, 1866. This gave the state banks a little over a year to get under cover. The necessity for this legislation becomes apparent if we consider that up to the 15th of November, 1864, there had been organized only 584 banks, having a capital of $81,961,450. Less than a year afterwards, on the 1st of October, 1865, there were 1,566 associations, capitalized at $276,219,450."

The state banks opposed this tax vigorously, and contested it in the courts, but its constitutionality was upheld by the United States Supreme Court in the important case

[1] 12 Statutes at Large, pp. 664–665.

[2] 13 Statutes at Large, p. 99.

[3] Secretary of the Treasury Salmon P. Chase, in the Report of the Secretary of the Treasury for the year ending June 30, 1863, had asked Congress to repeal this section so that the issues of national currency should not be connected with state banks in any way. He also favored some scheme for taxing state banks out of existence.

[4] Davis, Andrew McF., *The Origin of the National Banking System, etc.*, pp. 102–103.

of Veazie Bank v. Fenno, decided in 1869.[5] The effect was seen in the great decrease in the number of state banks from 1860 to 1868. In 1860 there were 1,562 state banks in the United States; by 1868 the number had fallen to 247.[6]

Soon after 1870, however, owing to local conditions which were favorable to the growth of state banking institutions, to the adoption of state laws which were more liberal than the national banking laws, and to a desire for smaller banks than could be organized under the national system, the state banking institutions began to increase. The increase is shown in the following table: [7]

	1879	1884	1889	1894	1899	1904	1909
National Banks.......	2,048	2,625	3,239	3,770	3,583	5,331	6,893
State Banks..........	813	1,017	2,097	3,705	4,253	6,984	11,292
Private Banks........	2,545	3,458	4,215	3,844	4,168	5,484	4,407
Trust Companies......	37	44	63	228	276	924	1,079

Fairly complete statistics of the banking institutions in the United States in 1882 were gathered under an act of Congress imposing a tax on the capital and deposits of banks. This law was repealed the next year so that no more statistics gathered in this manner are available until April 28, 1909, when another set of complete statistics was gathered for the National Monetary Commission by the Comptroller of the Currency and the state bank supervisors. The following table compiled from these statistics shows the comparative growth of state banks, trust companies, and national banks between those dates: [8]

[5] 8 Wallace 533. Act taxing state bank notes in 13 Stat. at Large 484.

[6] Barnett, George E., *State Banks and Trust Companies Since the Passage, etc.*, p. 11. Statistics here used are quoted from Barnett's book rather than from the reports of the Comptroller of the Currency because of the incompleteness of the statistics on state institutions in the latter publication.

[7] I bid., p. 201.

[8] Barnett, *The Growth of State Banks and Trust Companies.* An article in The Annals of the American Academy of Political and Social Science. November 1910, pp. 613-614. This article is excellent as a shorter account of the growth of state banking institutions than is contained in Professor Barnett's study for the National Monetary Commission.

	Number	Capital (in millions)	Deposits (in millions)
State Banks and Trust Companies, May 31, 1882	1,012	$116.	$ 452.
State Banks, April 28, 1909	11,319	416.	2,392.
Trust Companies, April 28, 1909	1,079	362.	2,812.
National Banks, July 1, 1882	2,239	477.	1,131.
National Banks, April 28, 1909	6,893	933.	4,636.

It will be seen from this table that the combined number of state banks and trust companies in 1909 was almost double that of the national banks, that the combined capital was somewhat less, and the combined deposits somewhat larger than those of the national banks.

This rapid increase in the number and importance of state banking institutions explains why it was that as the movement for banking and currency reform progressed after the panic of 1893 it came to be felt by many economists that no reform would result in the greatest benefits until state banking institutions could take advantage of it somehow without being compelled to convert into national banks. There was very little chance that the state institutions would reorganize with federal charters under a new system. It was believed that there would still be danger under any system which did not provide for assistance to more than one half of the banking institutions of the country. Many state institutions were permitted by state law to keep a large portion of their required reserves against deposits on deposit in other banks. The national banking law also permitted this. In financial emergencies of wide extent it was virtually impossible to withdraw these reserves because the banks holding them were usually in trouble as well. Some way had to be found whereby state institutions as well as national banks could borrow quickly on their liquid assets to obtain the actual cash necessary at such times. To force the state institutions to rely on the national banks for help was too fraught with uncertainty. The national banks might not be able or willing to render

assistance. Wholesale closing of national banks might be avoided under a new plan created for their benefit, but the danger of suspension of the state banking institutions would still remain.

As a result of the panic of 1893 many plans for banking and monetary reform appeared. The so-called Baltimore Plan drafted by the American Banker's Association in 1894, the bill submitted by the Indianapolis Monetary Commission of 1896, and numerous other proposals of that period directed their attention almost entirely to changes in the method of issuing national bank notes which would put an end to relatively inelastic bond secured currency. The panics which the country had experienced had shown that shortage of currency at critical times was an outstanding evil of the system as it then existed. The use of clearing house loan certificates was at best an imperfect expedient. Most of the proposed amendments suggested the substitution of asset currency, secured partly by gold, for bond secured note issues.

A plan proposed by Secretary of the Treasury Carlisle in 1894 differed from most of the others in that it would have again made possible the issue of state bank notes, by relieving the state banks from the 10 per cent tax, under certain conditions.[9] There were a number of unsuccessful attempts to repeal the state bank note tax during this period.

The Currency Act of 1900 made the situation more favorable to national bank organization. It made it possible to organize national banks with a capital of $25,000 in towns of fewer than 3,000 inhabitants and permitted national banks to issue notes to 100 per cent of the face or market value (whichever was the lowest) of the government bonds. This made it more profitable for state banks to convert and a number did so. This act was the extent

[9] Finance Report (Report of the Secretary of the Treasury), 1894, p. LXXVIII.

of the legislation accomplished from 1893 until after the panic of 1907.

As the memory of the monetary difficulties accompanying the panic of 1893 became dulled with the passage of time, the subject of banking reform seemed to lose some of its importance in the minds of the legislators and the general public. Many scientific students, however, refused to let the matter rest, realizing that so long as no reform was accomplished panics would be an ever-recurring phenomenon. Many members of the American Bankers Association also were well aware that action must be taken. At the St. Louis meeting in 1906 this association selected a currency commission to study the situation with a view to recommending a remedy.

The panic of 1907 brought matters to a head, and banking reform again became a topic of vital interest. Proposals to bring about relief were again in evidence in large numbers, but as before practically all of them left the state institutions out of their calculations. One result of the panic was the hurried passage of the Aldrich-Vreeland Act of May 30, 1908, and the creation of the National Monetary Commission. The Aldrich-Vreeland Act provided no way in which state banking institutions could take advantage of the proposed issue, through the National Currency Associations, of notes based on securities or commercial paper. However, state institutions might have borrowed from their national bank correspondents who became members of these associations, and thus indirectly have shared in the benefits.

This omission received severe criticism in many quarters. Senators Owen and Newlands objected vigorously. Senator Newlands said,[10]

> "I protest against this system of legislating for only one third of the banking system of the country. I protest against this system which perfects only the national banks of the country."

[10] Willis, H. Parker., *The Federal Reserve System.* New York: The Ronald Press, 1923, pp. 61 and 67.

By this time it was widely realized that something must be done for the state institutions as well as the national banks. Mr. Paul M. Warburg, who performed valuable service in educating the bankers and the public regarding the type of banking system needed, announced in 1910 a plan for a United Reserve Bank of the United States. In it he made provision for the membership of state banks and trust companies.[11]

The Muhleman plan also included state banks and trust companies. The Fowler plan did not.

In the first plan for monetary legislation submitted to the National Monetary Commission by its chairman, Senator Aldrich, membership in the proposed National Reserve Associations was limited to national banks.[12] That the state institutions were not forgotten, however, was shown by a speech made by Senator Aldrich in New York May 5, 1911, in which he stated: [13] "I am convinced that the interests of the public and of existing State institutions alike require that some means should be devised by which all classes should be permitted to participate upon some reasonable terms in the advantages and to share in the responsibilities of ownership and management of the Association." But, he added, the terms under which they might participate were difficult to decide upon.

After the publication of the first Aldrich Plan there was much discussion as to whether state institutions should be permitted to join and, if so, what should be the requirements for admission. William A. Scott expressed the opinion that if the state institution were to be required to convert into national banks before they would be eligible for

[11] "The Reform of the Currency." *Proceedings of the Academy of Political Science*, January 1911, Vol. I, No. 2, Columbia University, New York City, p. 307.

[12] Suggested Plan for Monetary Legislation, submitted to the National Monetary Commission by Hon. Nelson W. Aldrich. Senate Doc. No. 784, 61st Congress, 3rd session.

[13] 37 Proceed. A.B.A., 1911, p. 221. (This form of abbreviation will be used hereafter in references to the published reports of the annual conventions of the American Bankers Associations).

membership, there was a chance that conditions "would more closely approximate financial chaos than at present" should the state institutions refuse to become national banks. In such a case the influence of the reserve associations on the rate of discount would be greatly lessened.[14] O. M. W. Sprague stated that he believed it was possible so to liberalize the requirements of the Aldrich plan that the majority of the state institutions carrying on a commercial business would quite willingly enter the national system.[15] Neither of these two authorities discussed in any detail the possibility of the state institutions affiliating directly without converting. It was soon evident, however, that such affiliation would be permitted by the Aldrich plan when it was revised. Thereupon various commercial and financial organizations began at their meetings to pass resolutions approving the proposed membership of the state institutions in the National Reserve Association.

The Currency Commission and the Trust Company Section of the American Bankers Association appointed committees to make recommendations regarding this question.[16] The Currency Commission Committee advocated the extension of membership to state banks, trust companies, and savings banks (including mutual) upon the same terms as national banks. The committee of the Trust Company Section reported favorably on trust company membership provided certain changes were made as to the requirements for reserve, paid-up capital, and paper eligible for rediscount.[17] The Executive Council of the American Banker's Association unanimously approved membership of state banks and trust companies upon the terms recommended by the committee of the Currency Commis-

[14] Scott, Wm. A., The Aldrich Banking Plan, The American Economic Review, June, 1911, p. 260.

[15] Sprague, O. M. W., The Aldrich Plan for Monetary Legislation, American Economic Review, June, 1911, pp. 270–271.

[16] 37 Proceed. A. B. A., 1911, pp. 57, 447, and 502.

[17] 37 Proceed. A. B. A., 1911, pp. 543–546.

sion.[18] At the 1911 convention of the American Banker's Association, Mr. James B. Forgan remarked: [19]

"That these state institutions must in some way participate on equal terms with the national banks in all the benefits of the proposed plan seems to me inevitable. Unless they do, the defects in our banking methods, which are as germane to state as they are to national banks, will continue to exist among the great majority of our banking institutions. There is no greater solidarity in the one class than in the other. In times of financial stress State banks participate with the National banks in the struggle for cash reserves."

In October, 1911, Senator Aldrich submitted a revised plan which contained practically all of the foregoing recommendations regarding membership of state banks and trust companies. The first plan had ignored them, he said, because he had not then known what to propose.[20]

At the convention of the American Banker's Association in November, 1911, Mr. F. H. Goff, President of the Cleveland Trust Company of Cleveland, Ohio, discussed the question of membership in the National Reserve Association from the point of view of the state banks, savings banks, and trust companies.[21] The state institutions, he said, were gratified because the sections of the original Aldrich plan permitting national banks to operate branches and maintain savings and trust departments were not included in the revised plan. Many state institutions might have been compelled to go out of business had such provisions been enacted into law. He believed that many of the state institutions favored the Aldrich plan as a whole but that some of them disliked the reserve requirements and the power given to the National Reserve Association to require reports and examinations. Mr. Goff did not believe that membership of mutual savings banks would be

[18] *Ibid.*, p. 60.
[19] *Ibid.*, p. 26.
[20] Suggested Plan etc., revised ed., Oct., 1911, pp. 3 and 5.
[21] 37 Proceed. A. B. A., 1911, pp. 219–228.

advantageous for them. He favored giving the privilege of membership to state banks with a smaller capital than $25,000 if they were properly supervised, for it would tend to popularize the new system and lessen the danger of control by the large financial interests.

On November 24, 1911, this convention, with only one dissenting vote gave its unqualified approval to the revised Aldrich plan.[22] The popularity of the Aldrich plan among the bankers was due in part to the fact that membership in the National Reserve Association was purely voluntary, and control of the operations rested almost entirely in the hands of the bankers themselves. The favorable attitude of many of the state bankers is shown by the fact that over thirty state bankers' associations passed resolutions giving their approval.[23]

Opinion regarding the membership of state institutions in the National Reserve Association was, however, not uniform. Mr. George E. Roberts, at that time Director of the United States Mint, was one of those who thought that it would be sufficient to include only the city correspondents of the country banks in the system. All that was needed, he stated, was to make it possible for several hundred reserve city banks to secure assistance whenever they needed it, for they could be relied upon to take care of the other banks at critical times.[24] Mr. Thornton Cooke, then Vice-President of the Fidelity Trust Company of Kansas City, wrote as follows:[25]

"The suggestion heard recently, that state banks should be admitted to membership in the Association and given its facilities, is unwise. If the foregoing analysis of where the benefits of the Association would lie has been correct, the admission of state banks is entirely unnecessary. Few of them have great

[22] 38 Proceed. A. B. A., 1912, p. 63.

[23] *Ibid.*

[24] The Reform of the Currency, Proceed. Acad. of Pol. Sci. in the City of New York, Jan., 1911, p. 362.

[25] Cooke, Thornton, Financial Cooperation and the Aldrich Plan. Am. Ec. Rev., June, 1911, p. 249.

business with country banks. If they cared primarily for such business, they would already have reorganized as national banks. They all have accounts now with the large national banks, and depend upon them for assistance in times of stress. With the power of the national banks to render assistance greatly increased by the organization of the Association, it is unnecessary to give the state banks duplicate facilities, and it would certainly be unwise to introduce into the Association a class of banks that, however good their local supervision may be, are still outside the restrictions imposed by law upon the investments of the national banks, and outside the supervision of the Comptroller of the Currency."

The final report of the National Monetary Commission to the United States Senate in January, 1912, included a bill that had been drafted by the commission for submission to Congress. This was the Aldrich plan in its final form. All state banks and trust companies fulfilling certain requirements were to be permitted to subscribe 20 per cent of their paid-in and unimpaired capital to the stock of the National Reserve Association.[26] Of this amount 50 per cent was to be paid in upon joining and the rest was to be subject to call. To be eligible for membership the state banks had to have a capital of not less than that required for national banks in that locality. Trust companies should have an unimpaired surplus of at least 20 per cent of their capital and should possess paid-in and unimpaired capital as follows:

In places of less than	6,000		inhabitants	$ 50,000
In places of between	6,000	and 50,000	inhabitants	$100,000
In places of between	50,000	and 200,000	inhabitants	$200,000
In places of between	200,000	and 300,000	inhabitants	$300,000
In places of between	300,000	and 400,000	inhabitants	$400,000
In places of over	400,000		inhabitants	$500,000

State banking institutions, to be eligible, should agree to maintain the same reserves against deposits required of national banks. But the deposits which they might have

[26] Report of the National Monetary Commission. Washington: Government Printing Office, 1912, pp. 44-45.

with any member national bank, state bank, or trust company in a reserve or central reserve city might be counted as a reserve just as if they had been deposits of national banks with national banks in those cities. All member state banks and trust companies were to agree to submit to examination by the Association. Reports of state bank examiners would be accepted if satisfactory, where the state laws permitted the results of such examinations to be given to the Association's.[27] No interest would be paid by the Association on deposits.[28]

The state banks and trust companies were to receive equal privileges with the national bank members. They could become members of and share in the election of the directors of one of the local associations in their respective districts, of which there were fifteen. The National Reserve Association might assist the member state institutions by (1) rediscounting commercial paper made at least 30 days previous to the day of rediscount and having not more than 28 days to run, (2) purchase of bank acceptances of less than 90 days maturity, (3) rediscounting commercial paper of from 28 to 90 days maturity upon the indorsement of the local association, and (4) upon the approval of the Secretary of the Treasury, the governor, and the executive committee of the National Reserve Association, it might discount the direct obligation of a depositing member bank, when secured by satisfactory collateral and indorsed by the local association.

While the Aldrich plan failed of adoption because of the hostile attitude of the public which distrusted the large degree of control resting in the hands of the bankers and the "money trust," [29] the advocates of banking reform continued

[27] Report of the National Monetary Commission. Washington: Government Printing Office, 1912, p. 66.

[28] *Ibid.*, p. 60.

[29] For an explanation of the hostile attitude of the public toward the Aldrich Plan see Kemmerer, E. W., Banking Reform in the United States, and the ensuing discussion. Am. Ec. Rev. Supplement, March, 1913, pp. 52–73. Also see Willis, Henry Parker, The Federal Reserve System, pp. 83–89.

their labors vigorously.[30] Much of the information gathered at the time it was under discussion, and some of its more desirable features were used in the drafting of the bill which later became the Federal Reserve Act.

[30] One organization doing valuable work in educating the public during this period was the National Citizens' League, with headquarters in Chicago and branches in forty-five states. It published a widely circulated book, Banking Reform, edited by J. Laurence Laughlin, advocating important changes in the banking system.

CHAPTER III

STATE BANKS AND THE DRAFTING OF THE FEDERAL RESERVE ACT

IT WOULD seem from the account presented in the foregoing chapter that there would have been no question as to the wisdom of providing for the membership of state institutions in the Federal Reserve System.[1] But such was not the case. The first draft of the Federal Reserve Act, like the first draft of the Aldrich plan, made no mention of them. Henry Parker Willis, special expert for the House Committee on Currency and Banking, and later for four years Secretary of the Federal Reserve Board explained the omission in the following manner: [2]

"An important feature of the Federal Reserve Act is seen in the provision it makes for the unification of the banking system of the United States. The earlier drafts of the Glass bill, which afterward became the Federal Reserve Act, differed in theory, as respects this matter, from the final law. The first draft proceeded upon the view that with entrance to the national banking system perfectly free, and with the system entirely under Federal control, it was desirable to limit membership in Federal reserve banks to national institutions. Consequently it was provided that only national banks should be permitted to become members of Federal reserve banks."

Willis, himself, opposed the membership of state banking institutions. In a report to Chairman Glass of the House Committee on Currency and Banking he said: [3]

[1] See also the bill drawn up in 1912–13 by J. Laurence Laughlin which made extensive provision for membership of state institutions and gave power of withdrawal. *Banking Progress,* Scribners, New York, 1920. Chapter IX on A Proposed Bill.

[2] Willis, Henry Parker, *The Federal Reserve* New York: Doubleday Page and Company, 1915, pp. 256–257.

[3] Willis, Henry Parker, *The Federal Reserve System,* p. 122.

"The difficulty in the confining of the membership of the concern to national banks is simply the opposition of state banks and trust companies. Theoretically, it is very desirable that membership shall be confined exclusively to banks which owe their charters to the federal government. There seems to be little doubt that if the other classes of banks should be included as stockholders, there would be serious, if not practically insurmountable, problems growing out of the fact that these banks are not under immediate control by the federal government, that the state legislation pertaining to them varies very greatly from state to state and that the amount of their liability and the position of their stockholders, etc, differs widely."

A digest of the Glass bill was submitted to President Wilson in the summer of 1913. It showed that the relation of the state institutions to the new system had advanced a step nearer to a solution. This digest stated that it had not been thought wise to permit the state institutions to own stock in the National Reserve Banks, as they were then called, because the state institutions were under different management and control and there would be a difference in the laws under which the members would operate. But while they were not permitted to subscribe to stock in the new system, they were to be allowed to affiliate with the National Reserve Banks by maintaining the same deposits with them that were required of national banks. Those maintaining such deposits would be permitted to rediscount with the reserve banks, and were to be subject to inspection and examination by them.[4]

One more step was necessary, and that was to permit the state banking institutions to become stockholders. This was done in the bill as it was finally submitted to the House. One reason for granting membership in the system to the state banking institutions is stated by Willis to have been practical expediency It was pointed out that if the state

[4] Willis, H. Parker, *The Federal Reserve Act in Congress. The Annals*, January, 1922, pp. 44–45. This gives an excellent account of the legislative history of the Federal Reserve Act. Also see Willis, Henry Parker, *The Federal Reserve System*, p. 176.

institutions in the larger cities could not join a serious situation would develop in case of a panic if they outnumbered the national banks The national banks might leave the state institutions to their own devices with the result that the well-known evils would still reappear in time of financial stress.[5] In addition, it was seen that the larger the percentage of all the banks in the country which became members, the wider would be the influence of the new system and the greater would be the facilities afforded to the business men of all classes. Another reason given by Willis was that the state institutions demanded to be let in so as to be on a better competitive basis with the national banks.[6]

Once it was decided that the state banking institutions would be permitted to enter the new system disagreement manifested itself upon what the terms should be. Senator Owen's bill would have let any state bank or trust company join, but Willis wished the Federal Reserve Board to have the power to make the final decision. He argued that so many of the state institutions were in a weak condition that some competent authority should decide as to their fitness.[7] William Jennings Bryan seems to have concentrated his efforts on one point. He insisted that any issue of "emergency currency" should be made through the state banks as well as national banks.[8] Out of the chaos of conflicting opinions the Glass-Owen Bill finally emerged.

It was realized that if the state banking institutions were given the privilege of full membership, the national banks must be given additional privileges over what they then possessed or there might be large withdrawals from the national system. Many national bankers believed that the proposed retirement of national bank notes would force down the price of the 2 per cent government bonds securing them because of the loss of the note issue privilege. This

[5] Willis, Henry Parker, *The Federal Reserve*, pp. 258–261.
[6] Willis, Henry Parker, *The Federal Reserve System*, p. 805.
[7] *Ibid.*, p. 231.
[8] *Ibid.*, p. 254.

would result in a loss to the bankers. This fear was alleviated by providing that the retirement should take place very gradually. Permission was given the national banks, in spite of the opposition of the trust companies, to act as trustees, executors, administrators, and registrars of stocks and bonds. To satisfy the national banks even more, they were to be allowed to receive savings deposits, subject to only 5 per cent reserves. Those national banks which were not in central reserve cities were to be permitted, under certain restrictions, to lend a certain amount on real estate and farm lands. It was believed that such measures were necessary to prevent the national banks from reorganizing under state charters. A wholesale exodus of national banks would have broken the back of the federal reserve system right at the beginning.

While the Aldrich plan had met with wide approval among the bankers, the Glass-Owen Bill was most unpopular with them. The Currency Commission of the American Bankers' Association met in Chicago during August, 1913, with representatives from over eighty clearing house organizations and thirty state bankers' associations and drew up resolutions vigorously attacking the bill as it had passed the House. The chief objections were that too much power was given to the Federal Reserve Board, subjecting the banks to the dangers of political control, and that bankers were not sufficiently represented in the management. These features, it was alleged, made compulsory membership for national banks most undesirable. The resolutions declared that to insure the success of the new banking law it must receive the support of all the banks of the country in order that all business interests might be efficiently served. In view of their belief that the law in its form at that time could not receive the approbation of either the state or national banks the following amendments were suggested: (1) There should be not more than five federal reserve banks; preferably one, and that a cen-

tral bank; (2) membership in the system should be voluntary for all banks; (3) the amount that members were to subscribe to the capital stock of the federal reserve banks should be reduced; (4) dividends on the federal reserve stock should be 6 per cent instead of 5 per cent as then provided; (5) the directors of the federal reserve banks should be permitted to elect three members of the Federal Reserve Board; (6) the provisions requiring one federal reserve bank to rediscount paper for another federal reserve bank should be removed; (7) note issues should be obligations of the banks and not of the government;[9] (8) the reserve requirements should be liberalized; (9) the clause providing for par collection of checks should be greatly modified; and (10) the section of the law requiring segregation of savings deposits by national banks should be eliminated.[10]

A delegation headed by Mr. James B. Forgan of Chicago was sent by the bankers to appear before the Senate Committee on Banking and Currency to urge changes in the bill. The statements of some of the witnesses on particular questions bearing on the relationship of state banking institutions to the proposed system are instructive. Members of the Senate Committee questioned the bankers as to the likelihood of the state institutions entering the federal reserve system. Mr. Sol Wexler, Vice-President of the Whitney Central National Bank of New Orleans,[11] Mr. Festus J. Wade, of St. Louis,[12] and Mr. George M. Reynolds of Chicago, believed that the state institutions would join if satisfactory amendments were made.[13] Mr. James B. Forgan, of Chicago, expressed a contrary opinion and saw no particular advantage to be gained by including them.[14]

[9] Mr. Frank Vanderlip described the federal reserve notes as "fiat money." *Com. and Fin. Chron.*, Nov. 15, 1913, p. 1394.

[10] Hearings before the Senate Committee on Banking and Currency on the Federal Reserve Act. Senate Doc. No. 232, 63rd Congress, 1st session. Volume I, pp. 5–24.

[11] *Ibid.*, p. 67.

[12] *Ibid.*, p. 108.

[13] *Ibid.*, pp. 239–240.

[14] *Ibid.*, Vol. II, p. 668.

Mr. E. D. Hulbert of Chicago said that the success or failure of any plan depended upon the action of the state institutions, and he did not think enough attention had been paid to them in the drafting of the bill.[15] Mr. Breckenridge Jones of St. Louis was inclined to the view that the bill was favorable to the trust companies, but he wished to see it amended so that state institutions might join and retain the powers granted them under their state charters.[16] Mr. Thomas C. McRae, President of the Bank of Prescott, Arkansas, stated to the committee that the bill as a whole was favorable to state banks.[17] Mr. Oscar Newton, President of Jackson Bank, Jackson, Mississippi, held the opinion that the state institutions were needed in the system to popularize it and to make it work satisfactorily.[18] Mr. George W. Rogers, Cashier of the Bank of Commerce of Little Rock, Arkansas, declared that the bank of which he was an officer would not join as it would not be profitable.[19] Mr. S. D. Scudder, Vice-President of the Richmond Trust and Savings Company, stated that his bank would join if reasonable amendments were made.[20] Mr. Charles P. Blinn, Jr., told the committee that the bankers did not understand the bill.[21] Mr. Charles A. Conant held the opinion that the country banks would be as well off outside the system as in it, because they could rediscount with their correspondents in reserve cities. He did not believe that the membership of the state institutions was essential to the success of the system, and thought they should be allowed to rediscount without belonging to the system. He would offset this favor to the state banks by liberalizing the national banking law.[22] Mr. H. A. Moehlenpah, President of the Wisconsin Banker's Association and later a member of the

[15] *Ibid.*, pp. 1094–1095.
[16] *Ibid.*, Vol. II, p. 1019.
[17] *Ibid.*, p. 1275.
[18] *Ibid.*, p. 1642.
[19] Hearings before the Senate Committee on Banking and Currency on the Federal Reserve Act. Senate Doc. No. 232, 63rd Congress, 1st session, Vol. I, p. 1570.
[20] *Ibid.*, Vol. III, p. 2241–2242.
[21] *Ibid.*, Vol. II, p. 1183.
[22] *Ibid.*, pp. 1410 and 1450.

Federal Reserve Board, informed the committee that the Chicago conference in August had been a steam roller affair with the decision agreed upon beforehand, that the state bankers had not been well represented and had had little chance to be heard. He added that he wished membership might be made compulsory for the state institutions as well as for the national banks.[23]

Mr. Frank A. Vanderlip informed the committee that it was highly possible that the national banks would give up their national charters. At one point the following dialogue ensued:

> Senator Weeks. "If you were managing a state bank and this bill were put up to you as the law, you probably would hesitate about going in until you had seen how it was working?"
>
> Mr. Vanderlip. "Being in the fortunate position of having an option whether to go in or not, I would wait. I would take advantage of my position and see how it worked. I would see what this word 'regulation' meant. I would see what the success of the measure was likely to be."
>
> Senator Weeks. "Naturally, if other men felt in the same way, we need not expect to see State banks go into the system at once?"
>
> Mr. Vanderlip. "Not at once."

As will be seen later this testimony of Mr. Vanderlip was prophetic of the attitude of the state bankers during the first years of the Federal Reserve System. Mr. Vanderlip stated that all banks doing a commercial business would be desirable members.[24]

Several of the senators on the committee expressed the view that the country bankers had not been sufficiently considered in framing the bill, but H. Parker Willis assured them that the House Committee on Currency and Banking had endeavored to obtain full information con-

[23] Hearings before the Senate Committee on Banking and Currency on the Federal Reserve Act. Senate Doc. 232, 63rd Congress 1st session, Vol. I, pp. 1540–1541.

[24] *Ibid.*, Vol. III, pp. 1976–1980, 2057.

cerning their needs and desires and had drawn up the bill accordingly.[25]

The majority of the bankers showed intense opposition to the clauses providing for par collection of checks. This attitude was prophetic of the bitter controversy which was to arise later when the federal reserve system introduced its universal par clearing and collection system. Mr. James B. Forgan told the senate committee that this had been the most hotly debated question at the Chicago conference. Many of the large bankers favored and most of the small bankers opposed this clause.[26] Mr. W. F. McCaleb, President of the West Texas Banking and Trust Company of San Antonio, Texas, said that with regard to exchange charges the country banker was "a species of brigand." [27] The Currency Commission of the American Bankers' Association advocated changing this section until the only par collections would be between federal reserve banks.[28]

To summarize briefly. It was the consensus of opinion among the bankers appearing before this committee that if the bill passed as it then stood not only would the state institutions refuse to join, but many of the national banks would give up their national charters and become state institutions. It was the general belief that if the state institutions were permitted to ally themselves with the system they should do so on the same terms as national banks. The bankers were not agreed as to whether banks would actually make use of this rediscount privilege or whether the membership of state institutions was desirable. The majority, however, thought membership of the state institutions not only desirable but necessary for the success of the system. The small bankers protested vigorously

[25] Hearing before the Senate Committee on Banking and Currency on the Federal Reserve Act. Senate Doc. 232, 63rd Congress, 1st session, Vol. 1, pp. 3052–3055.

[26] *Ibid.*, Vol. I, pp. 192–199; Vol. II, pp. 1640, 1582; Vol. III, pp. 2308, 2195, 2215–2216.

[27] *Ibid.*, Vol. II, p. 1598.

[28] *Ibid.*, Vol. IX, see revised bill on p. 15.

against par collection of checks. The national bankers opposed compulsory membership. Certain bankers expressed a decided preference for a central bank. A number of bankers and economists realized the tremendous possibilities for inflation in the proposed methods of granting credit. Of the first importance, also, was the belief that it would be impossible to keep political influence with all of its accompanying evils out of the system, inasmuch as only one of the members of the Federal Reserve Board was required to be a banker, and as all of the members were to be appointed by the President instead of being chosen by the bankers themselves. However, very few of the provisions against which the bankers were protesting at this time were remedied to suit them in the law as finally enacted.

In October, 1913, preliminary to the annual convention of the American Banker's Association in Boston, there was a meeting of representatives of the small banks to give expression to the opinion of the country banker on the pending measure. The result was decidedly adverse to the bill. The reserve requirements and the par collection clause were especially criticized.[29] Resolutions were passed stating that unless the law was changed to please the bankers no state institutions would join and few national banks would be left in the system. Mr. Thomas C. McRae and Mr. H. A. Moehlenpah, both state bankers, sponsored a resolution indorsing the fundamental principles upon which the Glass-Owen bill was founded, but it was voted down overwhelmingly. The attitude of the bankers was further shown in the impatient attitude of those attending the main convention several days later, when anyone who tried to speak in defense of the bill was frequently interrupted and ridiculed.[30] Mr. McRae and Mr. Moehlenpah, as well as Mr. J. H. O'Neal, of Boston, and Mr. S. D. Scudder, of

[29] 39 Proceed. A. B. A., 1913, in *Com. and Fin. Chron.*, Oct. 18, 1913, pp. 168–169.

[30] 39 Proceed. A. B. A., 1913, in *Com. and Fin. Chron.*, Oct. 18, 1913, pp. 148–150.

Richmond, urged the Association to use diplomatic methods and not antagonize the mass of people in the country. But they had little success.[31] The Currency Commission of the Association attacked the proposed system in the following words: [32]

"There are a great many different kinds of socialism: but however the various theories differentiate, they all agree upon the fundamental proposition that the government, that is the community as a whole, should own all the real estate, all manufacturing enterprises, all banks, all transportation companies—in short, all money-making utilities. This proposition of the Government to take the bank's capital in the manner provided, carried to the extreme, would easily accomplish, so far as the national banks are concerned this contention of the socialists. For those who do not believe in socialism it is very hard to accept and ratify this proposed action on the part of the Government."

The convention again went on record as holding the belief that any system to be effective must secure the approval of all banks, both state and national.

The bill creating the federal reserve system became a law on December 23, 1913. Very few of the amendments desired by the bankers appeared in the completed act.[33] Willis has described the fight for the Federal Reserve Act as follows: [34]

"The currency and banking law of 1913 had to be pressed forward to a passage over the all but united opposition of those who had been engaged in the popularizing of 'sound' ideas on currency and banking and in the voicing of a demand for action,

[31] *Ibid.* Other bankers took a moderate view. See Howe, E. L., "The Country Banks and the Glass-Owen Bill." *Proceed. Acad. Pol. Sci. in N. Y.*, Oct., 1913, pp. 169–173.

[32] *Ibid.*, p. 127.

[33] See the list of objections on page 30 of which only numbers 3, 4, and 10 were remedied in the Act. While the subscription required was changed from 20 per cent of the capital to 6 per cent of the capital and surplus, the reduction was not so great as was commonly supposed because now the estimate was to be made on a larger amount.

[34] Willis, Henry Parker, *The Federal Reserve Act, Am. Ec. Rev.*, March, 1914, pp. 2–3.

notwithstanding that it embodies, and at every stage of its progress has embodied, the essential ideas regarded as fundamental by thoughtful students of the problem with which it deals. Selfish interests entwined about an obsolete and injurious system of banking have striven their utmost to discredit the legislation and to place obstacles in the path of its advocates; supposed experts have lent their services to the defense of the worse elements in the existing situation; and the press has too often done what it could both to misrepresent the facts and to discredit the motives of those who were honestly laboring for the fundamentals of reform."

After the passage of the Act the hostile attitude of the bankers moderated somewhat although they continued their attempts to secure amendments. The speech of President Arthur Reynolds, of the American Banker's Association, at the 1914 convention compared with his speech of a year before evidences a more liberal frame of mind and a desire to assist in the establishment of the new system instead of hindering it.[35]

When the national bankers saw that the federal reserve system was a reality, many of them, although not without considerable misgiving, decided to give the new banking system a chance to show what it could do. There was, however, much bitterness among them because they had been forced to join. There was considerable open hostility. But even these finally decided to join and make the best of what was to them a disagreeable situation. Practically none gave up their federal charters, although a great many were uncertain for some time as to what they would do.

Section 9 of the Federal Reserve Act which gave permission for the state banking institutions to become members had not received any large amount of criticism from the bankers while the bill was still in Congress. Most of the critics turned their guns upon the provisions laid down for all member banks, whether state or national. The hos-

[35] *Cf. Com. and Fin. Chron. Supp.*, Oct. 18, 1913, p. 144, with the same publication Oct. 24, 1914, pp. 132–133.

tile attitude of the bankers has been described at some length because it goes far in explaining why the state banking institutions refused to join for so long a period of time. The majority of the bankers agreed that if the state institutions entered they should be compelled to do so on the terms laid down for national banks, carrying the same reserves, and submitting to the same regulations, examinations, and supervision. There was some discussion as to whether state institutions should be permitted to withdraw from the system once they had entered, or be allowed to retain any of their state charter powers, but these questions were not given prominence. It must be remembered that it was the national bankers who led the opposition to the bill as they were the ones directly concerned. It is true that a number of state bankers and trust company officers appeared before Congressional committees. But the rank and file of state bankers were not deeply interested. Membership being for them a matter of choice and not compulsion they saw no need of worrying or making themselves heard.

CHAPTER IV

PROVISIONS OF THE ACT AND REGULATIONS MADE FOR STATE BANK MEMBERSHIP

THE sections of the Federal Reserve Act relating to the membership of state banking institutions will now be analyzed. Section 9 is the main section with which we are concerned. It authorized certain banks organized under a special or general law of any state to apply "to the Federal Reserve Board for the right to subscribe to the stock of the Federal reserve bank organized or to be organized within the Federal reserve district where the applicant is located." [1] All such banks must subscribe 6 per cent of their paid up capital stock and surplus to the stock of the Federal Reserve Bank, one half of this to be paid in, the other half to be subject to call.[2]

Not all banks chartered by the states were made eligible. To be admitted, a bank must possess a paid-up and unimpaired capital sufficient to allow it to become a national bank in the place where it is located. To comply with this requirement it must have a paid-up and unimpaired capital as follows:

In places of not over 3,000 inhabitants	$ 25,000
In places of over 3,000 but not over 6,000 inhabitants	$ 50,000
In places of over 6,000 but not over 50,000 inhabitants	$100,000
In places of over 50,000 inhabitants	$200,000

It will be seen at once that these requirements exclude

[1] The Federal Reserve Act as approved Dec. 23, 1913. See First Annual Report of the Federal Reserve Board, 1914, pp. 30–31. Section 1 of the Federal Reserve Act reads: "Wherever the word 'bank' is used in this act, the word shall be held to include State bank, banking association, and trust company, except where National banks or Federal reserve banks are specifically referred to."

[2] Section 2, Federal Reserve Act.

from the possibility of membership all those state banking institutions with less than $25,000 capital. But many state institutions with more than $25,000 capital are excluded because of the population requirements. For example, in a city of 50,000 or over, no bank can join if it has less than $200,000 capital. The McFadden-Pepper Bank Act of 1927 now permits banks to be organized in such cities with less than $200,000 capital where state banks can be so organized. The number of state institutions eligible for membership under these requirements was originally approximately eleven thousand; the number not eligible, exclusive of mutual savings and private banks, was approximately ten thousands.[3] Mutual savings banks, having no capital stock, may not join. Private banks are also excluded.[4] There was no requirement as to surplus.

The original reserve requirements were: banks in central reserve cities, 18 per cent against demand deposits; banks in reserve cities, 15 per cent against demand deposits; all other member banks 12 per cent against demand deposits. All members were to keep 5 per cent against time deposits. There was an intricate arrangement in the original act whereby the members were required to keep a certain percentage of their reserves in their own vaults, a certain percentage in the vaults of the federal reserve banks, and given the option of carrying the rest, for three years, either in their own vaults, the vaults of the federal reserve bank, or on deposit with national banks in reserve of central reserve cities. At the end of three years all reserves were

[3] Ninth Annual Report of the Federal Reserve Board, 1922, p. 29. (Hereafter annual reports of the Federal Reserve Board will be abbreviated thus: I Fed. Res. Board, 1914, 9 Fed. Res. Board, 1922). The Agricultural Credits Act of March 4, 1923, amended these requirements so that a bank with a capital of 60 per cent of the required amount can join if it will agree to increase it to the full amount within a period set by the Federal Reserve Board. Informal Ruling, Fed. Res. Bd., Fed. Res. Bull., Dec. 1, 1917, p. 950.

[4] Opinion of Counsel of Fed. Res. Board, Fed. Res. Bull., Sept. 1, 1917, pp. 693-694.

to be kept in the bank itself or in the federal reserve bank.[5]

When a state bank or trust company member was required or permitted by state law to keep a part of the reserve on deposit with another state bank or trust company, up to a certain limit these deposits might for three years be counted as legal reserve.[6] With this exception no member bank could keep on deposit with any nonmember a sum in excess of 10 per cent of its own capital and surplus. Also, no member institution could act as a medium or agent for a nonmember in applying for or receiving rediscounts from a federal reserve bank except with the permission of the Federal Reserve Board.[7] One half of the original reserve might be obtained by rediscounting eligible paper as prescribed in section 14.[8]

All members were required to submit to examination at least twice a year by examiners appointed by the Comptroller of the Currency. But the Federal Reserve Board might instead authorize and accept the examinations of state banks and trust companies made by the state authorities. Every federal reserve bank could, with the approval of its federal reserve agent or the Federal Reserve Board, make special examinations of members, the expense to be borne by the bank examined.[9]

[5] Federal Reserve Act, section 19. I Fed. Res. Board, 1914, p. 40. This section was amended by the Act of Sept. 7, 1916, to permit any member upon authorization of the Federal Reserve Board to keep in the federal reserve banks any portion of the reserve then required to be kept in its own vaults. It was again amended June 21, 1917, to require member institutions to carry all of the reserve in the federal reserve bank. The last amendment also reduced reserve requirements to 7, 10, and 13 per cent against demand deposits for banks not in reserve or central reserve cities, reserve city banks, and central reserve city banks, respectively. Reserves against time deposits were reduced from 5 to 3 per cent. These are the present reserve requirements. See 7 Fed. Res. Board, 1920, pp. 316-320.

[6] Federal Reserve Act, section 19.

[7] Federal Reserve Act. Section 19. I Fed. Res. Board, 1914, p. 40. The Federal Reserve Board later gave blanket permission to members to act in this way from August, 1921, until June, 1923.

[8] All of the reserve may now be obtained by rediscounting or borrowing.

[9] Fed. Res. Act, section 21. This section was amended June 21, 1917, so as to remove state institutions from the Comptroller's jurisdiction. See 7 Fed. Res. Board, 1920, p. 319.

Another stipulation of section 9 was that member state banks and trust companies must conform to certain restrictions imposed on the national banks. These were: a limitation of the liability that might be incurred by any person, firm, or corporation to such banks; a prohibition against making purchase of or loans on the stock of such banks; the withdrawal or impairment of capital; and the payment of unearned dividends. In view of these restrictions no member institution could lend an amount greater than 10 per cent of its capital and surplus to any one person, firm, or corporation.[10]

State member institutions were made subject to the provisions, prohibitions, and penalties prescribed by Sections 5198, 5200, 5201, 5208, and 5209 of the United States Revised Statutes. These sections enumerated various crimes and stipulated the punishment that should be accorded to the offenders.[11]

Reports of financial condition and of the payment of dividends had to be made to the Comptroller of the Currency as prescribed in Sections 5211 and 5212 of the Revised Statutes. Penalties were laid down in Section 5213 for failure so to report.[12]

If at any time a federal reserve bank believed that a member had failed to comply with the law or regulations, the Federal Reserve Board might, after a hearing, require the offending institution to surrender its federal reserve bank stock. Upon so doing, it would be repaid the amount of its stock subscription with accrued dividends at the rate of one-half of 1 per cent for each month which had elapsed since the last dividend payment. The expelled institution

[10] This section was amended June 21, 1917, to permit member state institutions to make loans in excess of this amount but prohibiting federal reserve banks from rediscounting any paper of any customer who had borrowed in excess of this amount. 7 Fed. Res. Board, 1920, p. 319.

[11] The constitutionality of this provision was upheld by the U. S. Supreme Court May 16, 1927 in C. O. Westfall vs. U. S. A., Fed. Res. Bull., June, 1927, p. 434.

[12] Since June 21, 1917, these reports need no longer be made to the Comptroller of the Currency.

might be restored to membership upon assurance that it would thereafter comply with the law and regulations.

All member state banking institutions could participate in the election of directors of the federal reserve bank.

All member state banks and trust companies were, like national banks, given in section 13 of the act the privilege of rediscounting at the federal reserve bank, notes, drafts, and bills of exchange arising out of actual transactions for agricultural, industrial, or commercial purposes. These notes, drafts, and bills of exchange must however not have been issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States. These notes, drafts, and bills of exchange must have at the time of rediscount a maturity of not more than ninety days, except those drawn or issued for agricultural purposes or based on live stock which might have a maturity of not exceeding six months.[13] The aggregate amount of such notes, drafts, and bills of exchange bearing the signature or indorsement of any one person, firm, or corporation which might be rediscounted by a federal reserve bank for any one member or trust company could not exceed 10 per cent of the unimpaired capital and surplus of the member institution.[14] This prohibition did not, however, apply to bills of exchange "drawn in good faith against actually existing values." Member banks might accept drafts or bills of exchange drawn upon themselves growing out of transactions involving the exportation or importation of goods and having not more than six months to run. But no member could accept such bills to an amount greater than 50 per cent of its paid-up capital stock and surplus. Acceptances based on the importation or exportation of goods, having at the time of rediscount a maturity of not more than three

[13] The maturity of eligible agricultural or live stock paper was extended to nine months by the Agricultural Credits Act of March 4, 1923, Section 404.

[14] See note 10 this chapter for change made June 21, 1917.

months, and indorsed by at least one member bank or trust company,[15] might be rediscounted by a federal reserve bank to an amount not greater than fifty per cent of the paid-up capital and surplus of the institution for which the rediscounts were made.

Section 16 of the Act was one that aroused intense discussion. It stated that the federal reserve banks should receive from member banks and trust companies on deposit, at par, checks and drafts drawn upon any of the depositors in the federal reserve banks. This section also gave the Federal Reserve Board power to require the federal reserve banks to act as clearing houses for the member institutions. Section 13, also important in the later organization of the federal reserve check clearing and collection system, will be discussed more fully in a later chapter.[16]

There was no provision in the Act as originally passed making it possible for member state institutions to withdraw should they so desire, or to exercise special powers allowed them under their state charters and state laws.[17]

The Federal Reserve Board decided that all applications for membership from state banks and trust companies should be referred to the Division of Audit and Examination of the Board. This division was authorized to communicate directly with the federal reserve banks and the state authorities. It was given power to call for the following supplemental information: (1) a copy of the last examination by the state authorities, (2) a statement of the

[15] Fed. Res. Act., Section 13. The Act of March 3, 1915, permitted the Federal Reserve Board, at its discretion, to increase the amount which a bank might accept and a federal reserve bank might rediscount up to 100 per cent of the paid-up capital and surplus of the bank requesting this privilege.

[16] Other sections of the act relating to the state institutions will be discussed in relation to particular problems; section 22 in the chapter "Why the State Banks Did Not Join," sections 13 and 16 relating to the clearing and collection of checks in the chapter on "Par Collection of Checks."

[17] This permission was granted by the amendments of June 21, 1917.

amount of loans, real estate investments, loans secured by real estate collateral, loans secured by the stock of corporations dealing in real estate, real estate mortgages held, with information as to the maturities of the investments; (3) the business affiliations of the officers and directors; (4) a statement of all other investments.[18]

It was believed that it was the intent of section 21 of the Act to permit the acceptance of examinations made by the state authorities wherever possible, and the Division of Audit and Examination began to investigate the methods of the state authorities to determine whether the standard would be acceptable. If it was found that a special examination was necessary it was planned to make it in conjunction with the state authorities.[19] It was believed that a high standard in these examinations would make it attractive and desirable for the state institutions to join.[20]

Circular No. 1 of the Reserve Bank organization Committee, dated February 14, 1914, stated that the state banks and trust companies upon entering the system might exercise those powers conferred by their state charters and which were not in conflict with the provisions of the Federal Reserve Act.[21] This committee drew up preliminary regulations under which the state institutions might enter. These were contained in Regulation Number 3, February 20, 1914, and stated that state institutions should file with their applications copies of their charters with a classification of powers as to those which had been exercised, those they desired to continue to exercise, and those which while granted they had not exercised and would not exercise should they become members of the federal reserve system. It was also decided that there was nothing in the Act to prevent members from depositing at the federal reserve banks checks drawn on nonmember banks and trust companies.

[18] I Fed. Res. Board, 1914, p. 51.
[19] I. Fed. Res. Board, 1914, pp. 51–52.
[20] *Ibid.*, p. 127. [21] *Ibid.*, p. 64.

When on August 4, 1914, the Aldrich-Vreeland Act was extended until June 30, 1915, the Secretary of the Treasury was given permission, at his discretion, to extend the benefits of this measure to those state banks and trust companies which had already joined or which agreed to join within fifteen days after the passage of the bill providing for the extension.[22] In the original draft of this amendment Senator Owen had inserted the provision that *all* state banks and trust companies with a capital of not less than $25,000 and a surplus of 20 per cent could exercise the privileges given by this act, but this was stricken out by the House Committee on Currency and Banking.[23] Little change in the attitude of the state institutions toward membership was brought about by this amendment to the Aldrich-Vreeland Act.

During the period of organization, the Federal Reserve Board was constantly studying the questions relating to membership of state banking institutions. It found these questions difficult to solve. At first it was believed that not much difficulty would be encountered in drawing up the regulations under which the state institutions might join, but, quoting from the first annual report of the Board:[24] "Investigation has shown that owing to differences in State laws, the comprehensive characters of the charters enjoyed by some State banks, and the complex conditions of competition between such institutions and their national competitors, the determination of these conditions was far from easy if an equitable adjustment was to be found."

In the meantime the members of the Federal Reserve Board were holding conferences with national and state bankers regarding the matter and found considerable differences of opinion. Some felt that if the conditions were

[22] *Ibid.*, p. 44.

[23] *Com. and Fin. Chron. Supp.*, Oct. 24, 1914, p. 125.

[24] I Fed. Res. Board, 1914, p. 20.

made too easy for the state institutions the national banks would give up their national charters, withdraw from the system, and possibly reenter as state institutions. On the other hand, should the conditions of state bank and trust company membership be made too severe none of them would enter. The problem was to encourage the state bankers to apply without causing dissatisfaction among the national banks.

The Federal Advisory Council was asked what suggestions it could make, but the extent of its advice was that the Council be allowed to scrutinize any regulations drawn up by the Board before they were finally issued.[25] This was done. The first draft of the regulations submitted for the consideration of the Council required the state institutions to have liquid paper eligible for rediscount to an amount equal to their capital and surplus before being permitted to become members. The Federal Advisory Council believed that this was too severe a restriction, that a requirement of from 25 to 50 per cent would be enough. This stipulation was entirely omitted from the regulations as finally published. The first draft gave the state institutions permission to withdraw, but the Advisory Council suggested some limit to the amount of federal reserve bank stock that might be cancelled in this way in any six months period. This suggestion was taken. The Advisory Council wished to have some definite limitation placed on the amount that could be lent by member state institutions on real estate security, but the Federal Reserve Board did not feel that this was advisable.[26]

Even before the issuance of the regulations announcing the principles which would guide the approval of membership of the state institutions several of them entered. By January 15, 1915, nine state banks and four trust companies with a capital and surplus of approximately $18,000,000 had

[25] 5 Fed. Res. Board, 1918, p. 775.
[26] *Ibid.*, pp. 776–781.

been admitted with the understanding that they would abide by any regulations which the Federal Reserve Board might establish. On this same date there were fifty-one applications pending, awaiting the publishing of the regulations.[27] Although the Reserve Bank Organization Committee had drafted regulations it was realized that they were only of a temporary nature and would be superseded by those which the Federal Reserve Board would promulgate in pursuance of the Federal Reserve Act. By May 1, 1915, three more state banks had been admitted.

When the regulations were finally issued, June 7, 1915, it was seen that every possible effort was being made to allay the apprehension of the state banks and trust companies that entrance into the system meant complete submission to the will of an autocratic federal authority. In Circular Number 14, series of 1914, the Federal Reserve Board stated:

> "A unified banking system, embracing in its membership the well managed banks of the country, small and large, State and National, is the aim of the Federal Reserve Act. There can be but one American credit system of nation-wide extent, and it will fall short of satisfying the business judgment and expectation of the country and fail of attaining its full potentialities if it rests upon an incomplete foundation and leaves out of its membership any considerable part of the banking strength of the country. The way must therefore be opened for State banking institutions to contribute their share to the capital and resources of the Federal reserve banks, in harmony with the intent of the Federal Reserve Act and in accordance with its provisions. State banks, trust companies, and national banks have their distinctive characters and places in the American banking organization, and these should be respected in coordinating them in the Federal reserve system." [28]

The Board went on to say that it would strive for strength rather than for a large number of members, but would try to be reasonable in fixing the standards for entrance. It

[27] I Fed. Res. Board, 1914, p. 20.
[28] *Fed. Res. Bull.* July 1, 1915, p. 145.

hoped that membership would bring prestige, and announced its intention of cooperating with the state authorities so as not to compel duplicating of examinations. It stated that the right to withdraw had finally been extended to the state institutions because it was felt that they would not join the system otherwise.

Regulations on State Bank and Trust Company Membership

The Federal Reserve Board announced that it would consider especially (1) the financial condition of the applying bank or trust company and the general character of its management; (2) whether the nature of the powers exercised by the applying institution, and its charter provisions, were consistent with sound banking and the standards of the federal reserve system; and (3) whether the laws of the state in which the applying bank or trust company was located contained provisions likely to interfere with the proper regulation and supervision of member banks. If in the judgment of the Federal Reserve Board, an applying bank or trust company conformed to all the requirements of the Federal Reserve Act and was qualified for membership, the Board would issue a certificate of approval. The Board would, whenever it seemed necessary, impose such conditions upon an entering bank as would insure compliance with the Act and these regulations.

Every member state institution could retain its full charter and statutory rights, and might continue to exercise the same functions as before admission, subject of course to the Federal Reserve Act and the regulations of the Federal Reserve Board. Such banks and trust companies could invest in loans on real estate or mortgages of a character and to an extent which, considering the nature of their liabilities, would not impair their liquid condition. Every entering institution should, within a period laid down by the Federal Reserve Board in each case, adjust, to con-

form to the provisions of the act and regulations issued, any loans it might have which were secured by its own stock, or loans to any one person, firm, or corporation aggregating in amount more than 10 per cent of its capital and surplus or more than 30 per cent of its capital. Any loans on real estate likely to impair the liquid condition of the banks or trust company must be so adjusted. The applying institution must agree to make such changes in its banking practice as the Federal Reserve Board recommended, and must not lower its standard of banking after admission.

Any member state bank or trust company was given the privilege of withdrawing from the system upon twelve months written notice to the Federal Reserve Board. At the expiration of this period the withdrawing institution would surrender its stock and be refunded the amount of its cash paid-in subscription with interest at the rate of one-half of 1 per cent per month since the last dividend payment. No more than 10 per cent of the capital stock of any federal reserve bank might be cancelled in this manner in any calendar year.[29] However, the bank might withdraw even if the 10 per cent limit had been exceeded, but the stock subscription with accumulated dividends would not be paid until the beginning of the next calendar year.

The Federal Reserve Board reserved the right to announce amendments to these regulations, and to make necessary additions, but no amendment to section 6, that section permitting withdrawals should take effect until six months after its adoption and issue by the Board.[30]

It will be seen that these regulations filled several gaps in the Federal Reserve Act by allowing the state institutions to retain their state charter and statutory rights and leaving them free to invest in loans on real estate and mortgages to an extent which did not impair their liquidity. In

[29] The 1917 amendments raised the 10 per cent limit to 25 per cent.

[30] For a complete copy of the present regulations governing the membership of state institutions see Appendix.

addition, right of withdrawal was now definitely supplied. In discussing the extension of the withdrawal privilege to the state institutions, Willis wrote:[31]

"The question which gave the Federal Reserve Board the most concern was undoubtedly that of the power of the State banks to withdraw from the system. Very early in the consideration of the whole subject, a committee was appointed by the American Bankers' Association with instructions to visit Washington and express the views of the State banks as a body (including trust companies) to the Federal Reserve Board. This committee came to Washington, but in giving its testimony failed to state with any degree of definiteness or accuracy exactly what State banks desired, or on what terms they would consider it feasible for them to be admitted to the system. The committee, however, was explicit in its belief that if the State banks were expected to come in at all they must be permitted to go out at will; otherwise, it was asserted, they would not be willing to become actual members. Division of opinion promptly manifested itself among lawyers with regard to such withdrawal, and some contended that, under the Act, State banks had no right to retire; while others held that the plain and unavoidable implication of the law was such as to make the withdrawal an obvious and proper exercise of power on the part of member banks. The consensus of opinion, however, seemed to be preponderatingly on the side of those who held that the State banks could legally and properly be permitted to withdraw from membership, and such provision was consequently embodied by the Federal Reserve Board in a circular issued June 7, 1915."

The Federal Reserve Board stated that the drafting of these regulations had taken a great amount of time and investigation and that the result represented the consensus of opinion. It added:[32] "The Federal Reserve Board regards the action taken in the State bank matter as being of the utmost importance to the future development of the system, and its action has been considered with a corresponding amount of care."

Shortly after the issuance of the regulations the Board

[31] Willis, H. P., *The Federal Reserve,* pp. 266–267.
[32] *Fed. Res. Bull.,* July 1, 1915, p. 117.

prescribed some further conditions for membership. These were that there must be attached to the application statements to the effect that (1) except with the approval of the Federal Reserve Board the applying institution would make no change in the general character of its assets or in any way lower the standard of its banking practices; (2) if the state institution was authorized by law in its state to accept domestic drafts, it must agree upon joining not to accept domestic drafts or bills of exchange unless based on transactions covering the shipment of goods, such transaction to be evidenced by accompanying shipping documents, or unless secured by warehouse receipts covering readily marketable staples, and it must also agree not to accept bills to more than one-half of its paid-up and unimpaired capital and surplus, unless so authorized by the Federal Reserve Board; and (3) if the bank was authorized by state law to establish branches it must agree not to open additional domestic or foreign branches except with the approval of the Federal Reserve Board.[33]

The question soon arose as to whether member state institutions might be used as government depositories. The Counsel of the Federal Reserve Board decided that although section 15 of the Act stated that government moneys might be placed on deposit in "member" banks, the word "member" in this case did not include state institutions but referred only to national banks. In the light of past legislation, he said, the right to receive government deposits must be expressly granted to state institutions by specific reference to them as a class. However the Postal Savings Act, made it possible for the state institutions to receive postal savings deposits.[34]

[33] *Fed. Res. Bull.*, Sept. 1, 1915, pp. 262–263.

[34] *Ibid.*, pp. 274–275. It was not until May 7, 1928, that the Federal Reserve Act was finally amended to give the state member banks the right to be designated as government depositories. *Fed. Res. Bull.*, June, 1928, p. 426.

CHAPTER V

MEMBERSHIP OF STATE BANKS PRIOR TO THE WAR

BY JANUARY 15, 1915, nine state banks and four trust companies with a capital and surplus of approximately $18,000,000 had been admitted to the federal reserve system. On this date there were fifty-one applications pending, awaiting the issuance of the regulations.

There was another way in which state institutions might become members and that was by converting into national banks. From the passage of the Act up to January 15, 1915, ninety-three state banks and trust companies allied themselves with the federal reserve system in this manner.[1]

By the end of 1915 nineteen more state banks had joined, bringing the membership of state institutions up to thirty-two.[2]

[1] I Fed. Res. Board, 1914, p. 20.

[2] Name of Bank	Capital	Surplus
Continental Trust Company, Washington, D. C.	$1,000,000	$ 100,000
Savings Bank of Richmond, Richmond, Va.	200,000	200,000
Bank of Woodruff, Woodruff, S. C.	40,700	10,500
Sullivan Bank and Trust Co., Montgomery, Ala.	250,000	25,750
Central Trust Company, Chicago, Ill.	4,500,000	1,000,000
Bank of Madison, Madison, Wis.	300,000	60,000
Mercantile Trust Company, St. Louis, Mo.	3,000,000	6,500,000
First State Bank, Dallas, Texas	250,000	21,500
First State Bank, Bonham, Texas	100,000	14,000
Citizens State Bank, Memphis, Texas	75,000	26,400
*First Guaranty State Bank, Pittsburg, Texas	....	....
Farmers and Merchants State Bank, Edgewood, Texas	35,000	7,000

* The First Guaranty State Bank of Pittsburg, Texas withdrew on January 18, 1917, Fed. Res. Bull., May 1, 1915, p. 371 Fed. Res. Bull. Vol. for 1915, pp. 29, 251, 314, and 347.

(Continued on Next Page)

After the issuance of the regulations prescribing conditions upon which the state institutions might join the Board began at once to examine the applications on file. It soon became evident that many of the banks and trust companies which had filed tentative applications were not going to enter. A number of them did not think the regulations were liberal enough. Others became fearful that succeeding boards might change the provisions, since the right to amend them had been expressly retained. Willis says many of the applicants lost interest because the Board had not welcomed them with open arms, and delayed issuing regulations.[3] Many of the officers of the system did their utmost to explain the operations of the federal reserve system during the period following the issuance of regulations, and repeatedly outlined the advantages of membership for state institutions. The Federal Reserve Board said that it had:[4]

Name of Bank	Capital	Surplus
Bank of Eufaula, Eufaula, Ala.	$ 100,000	$ 14,000
First State Bank, Savoy, Texas	25,000	3,500
First State Bank, Hamlin, Texas	25,000	1,750
First State Bank, Wolfe City, Texas	100,000	25,000
First State Bank, Bremond, Texas	50,000	25,000
Broadway Trust Co., New York City	1,500,000	750,000
Old Colony Trust Company, Boston, Mass.	6,000,000	6,000,000
Fidelity Trust Company, Kansas City, Mo.	1,000,000	1,000,000
Elmhurst State Bank, Elmhurst, Ill.	60,000	25,000
Badger State Bank, Milwaukee, Wis.	200,000	2,000
Fort Scott State Bank, Fort Scott, Kan.	100,000	25,000
German-American Bank, Minneapolis, Minn.	200,000	200,000
Fruit Growers State Bank, Saugatuck, Mich.	50,000	10,000
Bank of Lewellen, Lewellen, Neb.	25,000	10,000
Central Bank & Trust Co., Dallas, Texas	200,000	....
Bank of Hartsville, Hartsville, S. C.	50,000	50,000
Commercial Trust & Savings Bank, Joliet, Ill.	100,000	5,000
Commercial & Savings Bank, Albion, Mich.	50,000	25,000
Guardian Trust & Savings Bank, Toledo, Ohio	200,000	200,000
Merchants & Farmers Bank, Cheraw, S. C.	100,000	1,250

[3] Willis, Henry Parker, *The Federal Reserve System*, pp. 807–808.
[4] 2 Fed. Res. Board, 1915, pp. 13–14.

"Deemed it wise to offer to all eligible state institutions the utmost freedom in associating themselves with the system, in order that there might, if possible, be developed a uniform banking system embodying as large a proportion as possible of the eligible commercial banks of the country under a single general oversight for the same general purpose—the prevention of stringency or financial difficulty and the strengthening and enlargement of the financial resources of the country. . . . It is scarcely necessary to say that the credit resources of the country would be greatly enlarged and strengthened, with corresponding benefit to business and to all the people of the country, were the State banks and trust companies to be joined together with the national banks in the homogeneous and well organized banking system provided by the Federal Reserve Act. . . . The Board is satisfied that the State banks gain in safety and the States sacrifice none of their prerogatives or powers when such banks become members of the Federal Reserve System."

In 1916, however, the movement into the system slackened considerably. Only six state institutions entered in that year.[5]

Distributed by districts, membership of state institutions on December 31, 1916, was as follows: Dallas 10, Chicago 8, Richmond 6, Atlanta 4, Kansas City 3, New York 2, St. Louis 1, Cleveland 1, Boston 1, Minneapolis 1, Philadelphia 0, San Francisco 0. The capital of these institutions was approximately $24,000,000 with a surplus of about the same amount. More than one half of the banks were in the southern districts. This is not surprising, for the Act being passed under a Democratic adminis-

[5] Name of Bank	Capital	Surplus
Peoples' Bank, Sumter, S. C.	$ 100,000	$ 17,400
First State Bank, Dekalb, Texas	25,000	25,000
Corn Exchange Bank, New York City	3,500,000	6,991,165
American Trust & Savings Bank, Birmingham, Ala.	500,000	250,000
Bankers Loan & Trust Co., Sioux City, Ia.	100,000	5,000
Bank of Iota, Iota, La.	25,000	none

tration was well known to be more popular in the South than in the North.

Certain state bankers were afraid that the Board might attempt to restrict the activities which they were exercising under their state charters. They urged the Board to make a more definite statement on this matter. To one such banker the Board replied [6] that since the power to adopt any specific regulation involved a question of law which must be determined by the facts in each case it was not practicable to outline definitely the scope of all future regulations. The Board would impose only those regulations which were deemed necessary to carry out the purposes of the Act. It did not feel that it was one of its functions to undertake to restrict state banks and trust companies in the exercise of true banking or trust company powers as defined by the laws of the state in which they were situated. The Board would approve only those applications which came from banks and trust companies which were solvent and whose membership would not weaken the system. The possession of any definite amount of eligible paper for rediscount was not made a prerequisite for membership.

In a portion of this letter to the state banker the Board stated that it believed that the state institutions would find membership advantageous whether they had any paper eligible for rediscount or not, for they could secure assistance from another member bank which did have such paper eligible for rediscount. The ability to help member banks directly or indirectly would increase as the strength and lending power of the federal reserve system increased with a growth in membership. In times of financial stress, nonmember institutions might find that they were unable to secure assistance from anyone, while all members could undoubtedly be taken care of.

[6] *Fed. Res. Bull.*, Aug. 1, 1916, pp. 393–394.

Continuing in its attempt to clear up its position the Board explained to this state banker that if the state bank or trust company exercised functions under state law which might impair its liquidity or lead to overextension, the federal reserve bank would be compelled to examine the status of such a member very carefully if it asked for a rediscount. The exercise of certain powers might lead the Federal Reserve Board to reject an application for membership, but once the institution had become a member the Board would interfere with the functions allowed by the state charter only where the performance of such functions impaired the liquidity and soundness of the member bank or trust company.[7]

While this constituted an important statement at this time, it was still rather indefinite for many of the state bankers who were unable to decide just what they would be able to do. The Board emphasized the fact that the possession of paper eligible for rediscount was not a prerequisite for membership and told the nonmembers that they could not expect assistance in emergency periods. This last statement was in some quarters looked upon as a form of threat to nonmembers. Ground for this belief was given in a letter from an officer of a federal reserve bank to an officer of a state bank early in 1917.[8] He stated that the nonmembers should join while they were still welcome. Later, if they experienced difficulty, they might find that they would not be received into the system. It was therefore dangerous to postpone making application.

What was happening to the national banks during the same period? Were they growing or decreasing in number? It has already been stated that only a few of them refused to join. An important question is whether their rate of in-

[7] *Ibid.*

[8] *Ibid.*, Feb. 1, 1917, pp. 84–87.

crease was slackening. The following table answers this question:[9]

Date	Number of National Banks	Yearly Increase
June 30, 1907	6306	....
" " 1908	6432	126
" " 1909	6797	365
" " 1910	7043	246
" " 1911	7186	143
" " 1912	7307	121
" " 1913	7404	97
" " 1914	7453	49
" " 1915	7560	107
" " 1916	7571	11
" " 1917	7589	18

Of the banks operating under national charter, 5,007 filed resolutions accepting the provisions of the Federal Reserve Act, inside of the first month after the passage of the Act.[10] Only 28 failed to qualify within the time limit.[11] There was some fear that the National City Bank, the largest national bank in the country, would give up its charter rather than join. When it finally agreed to enter many of the still hesitant banks decided to do likewise.[12]

[9] Reports of the Comptroller of the Currency. Subsequent figures are as follows:

Date	Number of National Banks	Yearly Increase
June 30, 1918	7691	102
" " 1919	7762	71
" " 1920	8025	263
" " 1921	8150	125
" " 1922	8244	94
" " 1923	8236	8*
" " 1924	8079	157*
" " 1925	8066	13*
" " 1926	7972	94*
" " 1927	7790	182*
Feb. 28, 1928	7728	62*

*Decrease.

[10] *Com. and Fin. Chron.* Jan. 24, 1914, p. 278.

[11] *Ibid.*, Feb. 28, 1914, p. 655.

[12] *Ibid.*, Jan. 31, 1914, p. 359.

While the foregoing table shows an increase for each year, it will be observed that this increase during the first five years of the federal reserve system averaged considerably less than for the five preceding years. The years 1914, 1916, and 1917 were exceptionally low years. Part of the decrease was due to the fact that the number of new national banks organized declined. More important, a number of national banks reorganized under state charters although they had originally been members of the system. Most of them did not at once reënter. While the wholesale converting of national banks into state banks that had been prophesied did not materialize, the uncertainty occasioned by the organization of the new system resulted in a decline in the rate of growth, and the liquidation of a large number of the national banks. The statistics regarding new applications and liquidations bear out this conclusion. From November 16, 1914, to December 31, 1915, there were 155 new national charters issued, as opposed to 56 liquidations for purposes other than consolidating with other national banks.[13] During 1916 there were 248 applications for national charters, only 122 of which with a capital of $6,890,000 were granted. Of these 48 were conversions of state institutions. In the same year 102 national banks with a capital of $9,233,000 liquidated. During 1917 there were 291 applications received, 194 of these with a capital of $12,085,000 being approved. Of this number 57 were conversions of state banks or reorganizations of state or private banks. During this year there were, exclusive of consolidations with other national banks, 74 liquidations withdrawing a capital of $6,522,500.[14]

Many of the withdrawals from the national system were due to a feeling that state charters were more profitable. The federal reserve agent of the Boston district, reported: [15] "No definite, well defined reasons can be as-

[13] *Fed. Res. Bull.*, June 1, 1916, p. 265.
[14] *Ibid.*, Feb. 1, 1918, p. 89.
[15] 3 Fed. Res. Board, 1916, pp. 199–200.

signed for the changes from national to State charters made by these banks. There is the impression which is referred to elsewhere and should be dispelled that a State bank may receive all of the benefits of the federal reserve system through its city correspondents without contributing to its support." By 1918, however, this federal reserve agent was able to report that the movement out of the national system had stopped and that some of the banks were reëntering the federal reserve system as state institutions.[16] The federal reserve agent at Cleveland, in commenting on the withdrawals in that district, gave as the reason that most of them were in country districts and wished to make more loans on real estate than were permitted to national banks. But there were other reasons as well. The federal reserve agent at Kansas City reported in 1916 that a number of national banks in Nebraska had converted into state institutions because of the popularity of the state law guaranteeing deposits, to take advantage of which they had to reorganize as state banks.[17] The industrial depression of 1914 was responsible for a number of liquidations.

It has frequently been stated that the chief reason why the national banks did not withdraw in larger numbers was because they feared that in that case a large number of the 2 per cent government bonds owned by the banks, securing national bank circulation, would be thrown on the market, driving down the price and causing a heavy loss to the withdrawing banks. The fact that the Federal Reserve Act provided for a very gradual retirement of the national bank note circulation did much to alleviate the apprehensions of the national banks.

While during 1916 and 1917 there were 176 liquidations among national banks, yet during the same period 105 state institutions entered the federal reserve system by becoming national banks. The number of state institutions

[16] 5 Fed. Res. Board, 1918, pp. 274–275.
[17] 3 Fed. Res. Board, 1916, p. 394.

to affiliate directly was however much smaller, only 53 being listed as members on June 21, 1917.[18]

It can well be inquired at this point whether the first state institutions to apply for membership in the system regretted having done so. Were their experiences favorable or unfavorable? Fortunately there is direct evidence on this point. In the Federal Reserve Bulletin of May, 1917, were published letters from thirty-two member state institutions. These letters had been written in reply to an inquiry from a bank which was considering making application.

The inquiring banker had asked these members why they had joined. The Corn Exchange Bank of New York replied, "The principal reason why we joined was that we felt, being the largest State bank in this country, it was our duty to join with the other large banks in trying to make the Federal Reserve System a success; also the fact that when we were considering the subject we ascertained all the objections to the system were of a picayune nature and not of sufficient importance to warrant our not joining." The Central Trust Company of Chicago also believed membership to be a patriotic duty. It also desired to place itself in a position in which it could borrow directly in time of stress rather than through a national bank. The Old Colony Trust Company of Boston gave similar reasons.

The banks were asked to state what advantages had accrued to them through membership. The answers varied considerably. The First State Bank of Hamlin, Texas, saw no advantage except, perhaps, for advertising purposes. The First Guaranty State Bank of Pittsburg, Texas, experienced so few advantages that it withdrew on January 18, 1917. Four other banks saw no advantage in membership. The Fort Scott State Bank of Fort Scott, Kansas, stated the only profit it had realized was that it had been able to retain $15,000 of postal savings deposits which

[18] 5 Fed. Res. Board, 1918, p. 25.

otherwise it would have lost. The Savings Bank of Richmond, Virginia, and the Mercantile Trust Company of St. Louis had derived little of value except possibly having gained prestige with the public. Other than possibly being looked upon with heightened respect by the public, The Broadway Trust Company of New York and the Old Colony Trust Company of Boston claimed that the only advantage to them was that their acceptances sold in the market at a better rate than the acceptances of nonmember banks and trust companies. The advantages most frequently mentioned were:

1. The rediscounting privilege which made it possible to secure funds quickly and cheaply from the federal reserve banks. This gave a feeling of security, and inspired confidence on the part of the public in the bank. A number of the bankers recalled their experiences in former panics and crises when they needed help and could not obtain it from their correspondents who were also in need at the same time. This feeling of uneasiness and dependence on some other bank had been dispelled by membership. It meant a great deal to the bankers to know that they were tied up to the central reservoir of credit.

2. A number of bankers mentioned that under the check clearing and collection system they were able to render additional facilities to their customers, and save money.

3. A number considered membership to be advantageous as an advertising feature in the securing of new business, because they found that the public would regard a bank more highly which could advertise that it was subject to federal examination.[19]

4. Several of the banks mentioned that they were able to carry smaller reserves than before, and that thereby they

[19] Some of the banks advertised that they were under federal "supervision." At first the Federal Reserve Board made little objection to this, but later stated that this should be discontinued as the degree of control was not sufficient to be termed "supervision." It was unobjectionable, however, to state that they were subject to federal examination.

were able to increase their lending power and increase their profits.

5. Three banks mentioned that their acceptances would sell at a better rate than before.

6. Several banks stated that formerly they had been compelled to carry large balances with correspondents in order to be able to borrow and have checks on other banks collected for them. This was now no longer necessary.

A list of the advantages mentioned with the number of banks naming each follows:

Rediscounting privilege	13	Gain in public confidence	4
Feeling of security	12	Prestige	4
Clearing of checks	11	Increased lending power	4
Advertising asset	7	Better rate on acceptances	3
Ability to borrow at better rate	6	Postal savings deposits	3
		Lower reserves	3
Federal supervision	4	Foreign branches	1

The banks were requested to name any disadvantages which they had encountered. Nine replied that they had found none.

A list of the disadvantages mentioned, with the number of banks mentioning each is given below: [20]

Nonpayment of interest on deposited reserves	11
Extra work from red tape, reports, examinations	10
Loss on exchange charges	8
Restrictions on loans	7
Improbability of dividends	5
Clayton Act prohibition on directorates	1

It should be noted that while par collection was an advantage to 11 banks it caused a loss to 8. Six banks reported that they had not been affected by the collection system since they had not taken advantage of it, while several others were uncertain as to its effect.

It was the consensus of opinion among the banks that with the exception of the restrictions on loans neither their

[20] For a more complete discussion of disadvantages see the next chapter.

charter powers nor their methods of doing business had been affected by membership. On the other hand, membership had given them no additional powers.

The banks were asked to state their opinions upon the advisability of other banks joining the system. With the exception of several of the small Texas banks there was universal agreement that membership was highly desirable. The larger banks and trust companies were generally the most emphatic in their statements of the desirability of the state institutions entering the system. Most of the doubtful banks answered that where a bank did not need rediscount facilities the non-payment of interest on the required deposited reserve caused a loss that offset the advantages of membership. But even the First Guaranty State Bank of Pittsburg, Texas, which had withdrawn in January because of the loss from the non-payment of interest on its reserve wrote: "The Federal Reserve System is the greatest piece of legislation enacted in recent years and it is entitled to our hearty support." An officer of the Broadway Trust Company of New York wrote:[21]

"I, of course, think all banks should join the system Before actually joining it ourselves, I called on practically every bank in New York City to obtain their ideas, also upon a number of banks in Philadelphia, Boston, and other cities. I found a well defined prejudice in the minds of many national-bank men, as well as State-bank men, but the prejudice seemed to me to be based on a dislike of or lack of faith in the powers that be at Washington, and I have to admit that in many cases I found a great lack of information concerning the terms of the act and the workings of the Federal system. In any event, I have never heard from any source anything that I can construe as a good reason for not joining, unless it be the loss of earnings due to the fact that the Federal Reserve Bank pays no interest on the balances on deposit with it. On this point I feel that this loss may properly be considered as the premium on safety insurance."

After reading the replies it must be concluded that

[21] *Fed. Res. Bull.*, May 1, 1917, pp. 360–361.

membership was considered to be advantageous by approximately 75 per cent of the member state institutions. While a number saw no advantage only one had deemed it wise to withdraw.

Some economists and bankers had believed that par collection of checks would prove to be the greatest advantage of all for the state banks and trusts companies who joined. Conway and Patterson wrote: [22]

"The most important of the advantages to State institutions entering the system is that they will be able to receive from the reserve banks immediate credit at par for all checks and drafts on other member banks within the district and will also be able through the same provisions of the Act to have checks and drafts on themselves pass at par within the district." This position was also taken by the Secretary of the Federal Reserve Board in 1914.[23] But as will be seen later the state institutions as a whole did not share this view.

After considering the advantages of membership as given by the first state institutions entering the system it might seem there was no reason why more state institutions should not have joined. Undoubtedly a large number of them would have found membership advantageous. On the other hand, there were sound reasons why others remained outside, although many of their apprehensions were shown in time to have been without substantial basis. The fact that the majority of the bankers whose experiences have been related in this chapter found little to complain about should have done much to quiet the fears which were so widely entertained at this time by the state institutions. From the standpoint of public security, of course, a more rapid alliance of the state institutions with the federal reserve system was highly desirable. The conditions which the Act sought to remedy could only be partly alleviated while

[22] Conway and Patterson. *The Operation of the New Bank Act*, p. 376.

[23] 40 *Proceed, A. B. A.* 1914, pp. 296-7.

so many remained outside. Some public spirited bankers saw the situation in its true light. Mr. C. C. K. Scoville, President of the Citizens State Bank of Seneca, Kansas, summed up the question of membership in the following manner: [24]

"Let us assume, however, that joining the Federal reserve system does involve certain sacrifices, some of which are necessary, and some of which may be thought unnecessary. If you throw into one side of the scale all the benefits accruing to the banks and the nation by the creation of the Federal reserve system, and into the other the sacrifices to be made by its members, there cannot be any doubt whatsoever that the advantages will outweigh the disadvantages a thousandfold."

A vigorous warning was given to the reluctant state institutions by Mr. Festus J. Wade, President of the Mercantile Trust Company of St. Louis, whose bank was one of the first state institutions to enter: [25]

"Let some of these state bankers or trust company officials (doing a banking business) answer this question! Where will they go in times of panic, which must inevitably come, when national banks and member banks will no longer find the necessity of issuing clearing house certificates, each indorser for the other? How will the nonmember banks get currency to compete with the member banks? How will they manage under such distressing circumstances to compete with the member bank, which can always go to the Federal reserve bank of its district for succor and assistance in the hour of need, if their assets are clean and sound. Remember, during such periods, friendships made at bankers' conventions cease to exist. Each banker in each community has all he can do to care for himself, and only through force of circumstances for his own protection and for the protection of commerce in the past have clearing house certificates been used. That expedient will be eliminated in the future because member banks will have no necessity for indorsing notes on nonmember banks, which had equal opportunity to join the Federal reserve system, and thus help to protect the credit and commerce of the nation."

[24] *Journal A. B. A.*, March, 1917, p. 773.
[25] *Journal A. B. A.*, May, 1916, pp. 991–992.

Such warnings had little effect upon the movement of state institutions into the system. It was realized from the beginning, however, that it would not be desirable to include every state bank and trust company which was eligible. H. Parker Willis, Secretary of the Federal Reserve Board, late in 1914 tried to designate the type of state institutions which should enter. The federal reserve system, he said, was a commercial banking system and therefore it was not desirable that any bank or trust company should join unless it was doing a commercial banking business. Investment bankers, for instance, could gain little by becoming members, nor would they benefit the system by so doing. Those who said that every eligible institution should apply for membership made this statement more from enthusiasm than from a knowledge of what the federal reserve system aimed to accomplish. The Secretary said that banks did not need to become members in order to benefit from the establishment of the new banking system, for if the federal reserve banks were successfully and efficiently operated nonmembers would benefit indirectly by being able to dispose of their paper on the open market on more favorable terms than before.[26] In his opinion, then, the state institutions need not join if all they wanted was the privilege of rediscounting their paper. This statement of Secretary Willis was widely quoted as showing that there was no immediate need for the state institutions to ally themselves with the system.

[26] 40 *Proceed. A. B. A.*, 1914, pp. 296–297.

CHAPTER VI

WHY THE STATE BANKS DID NOT JOIN

THE Federal Reserve Act was signed by the President in December, 1913. The federal reserve banks opened for business one year later. Yet by June, 1917, only fifty-three out of 10,000 eligible state banking institutions had seen fit to ally themselves with the system. This situation existed in spite of the efforts of the Federal Reserve Board and the officers of the federal reserve banks to induce them to make application. Although Willis claims that the members of the Board were not very cordial toward the state institutions that were applying, W. P. G. Harding, at the convention of the Alabama Bankers' Association at Birmingham, May 12, 1915, urged the state institutions to join. The Federal Reserve Board was eager to have them all in one coördinated banking system, one credit system of nation wide extent. But he said the Board was more concerned about the quality of the banks comprising the membership than the quantity of them enrolled. It was desired to set up standards which would keep out the weak banks.[1]

Many state banks, however, either were not interested or were waiting to observe how the system was going to work. The annual reports of the federal reserve agents contain much evidence on this point. The national banks had been compelled to join and had done so with many protests. The state banker, being able to make a choice, wished to see whether the new system was to be a success. Prophecies of evil consequences which would result from the establishment of the federal reserve system had been

[1] *Com. and Fin. Chron.*, May 29, 1915, p. 1792.

so common among the bankers that the state banker or trust company officer saw no reason to hasten into the system. Many of them claimed that they saw no advantage to be derived from membership, anyway. All of their needs were being supplied by their city correspondents.

The Guaranty Trust Company of New York published in July, 1916, the results of a nation wide survey of opinion on the Federal Reserve Act. It revealed a deplorable amount of indifference on the part of state bankers, many of whom acted as if the new system did not concern them.

It is easy to understand the reluctance of the bankers when we recall all the criticisms that had been made against the new system. Senator Aldrich, whose plan had been so greatly favored by the bankers, had been especially antagonistic. In a rather lengthy address at the dinner of the Academy of Political Science in New York, October 15, 1913, the Senator said among other things: [2]

"The proposals with reference to note issue are radical and revolutionary in their character and at variance with all the accepted canons of economic law. . . . With legislation depriving the national banks of the advantages which they now have and imposing upon them new and onerous burdens, and with the state institutions retaining all the advantages which they now have, it is not unreasonable to expect the decline if not the extinction of the national system". . . . "It (the Federal Reserve Board) is given, improvidently, autocratic powers over business of the banks, which can only be successfully managed by men who own and control existing institutions and who are familiar with all local conditions . . . . In great emergencies when some sustaining power is necessary, it will be powerless. . . . It might be able to control elections and insure the success of a political party, but, in times of stress, it would have no power to preserve public or private credit. It would be able to loan government notes to impecunious banking friends or to deposit government funds in 'pet banks', but it would be unable to assist a bank or a community in time of serious trouble. It would have no status in the commercial world, and its standing at home

[2] *Proceed. Acad. Pol. Sci.* in the City of New York, Oct., 1913, pp. 37, 71, 77, 86, and 87.

would be fixed by its importance as a political machine rather than as a force in financial circles. . . . The creation of this board, with its improvident grants of executive and legislative authority, is repugnant to every fundamental principle of popular government. No instrumentality could be further removed from popular control. The functions of the board are exercised in secret and there is no provision for publicity of any kind, except an annual report to Congress. There can be no review of its opinions and no appeal from its decisions. . . . The creation of this board, however, is clearly a favorable response to socialistic demands."

It will be recalled that the Currency Commission of the American Bankers' Association had also attacked the bill as being socialistic in principle.

This critical attitude was found in the ranks of the economists as well. E. R. A. Seligman at the same meeting of the Academy of Political Science uttered this warning: [3]

"Passing over a number of minor points which this would not be the place to discuss, because of lack of time, I shall simply call attention to the fundamental fact that the proposition of twelve regional reserve banks flies in the face of all sound theory. I venture to assert without fear of contradiction that if the economists and the thinkers of this country were called together in conclave to-day, there would scarcely be a dissenting voice on this point, and there would certainly be an overwhelming majority to the effect that this proposition—the most fundamental proposition, in most respects, of the bill—is incorrect, and if persisted in will make the whole measure either a failure, or, at all events, very largely impotent to bring about the result which we all desire."

At the same time, another economist, Joseph French Johnson, gave expression to his fears in these words: [4]

"The Owen-Glass bill creates an entirely new kind of banking machine. Nothing like it has ever been tested by this or any other country. In many of its details it resembles established banking institutions, but in its essentials, in its anatomy, so to

[3] *Proceed. Acad. Pol. Sci.* in City of N. Y., Oct., 1913, p. 135.
[4] *Ibid.*, p. 151.

speak, it resembles no bank with which the world has had experience. If by mandate of Congress it were put into operation, I believe that within two or three years it would bring this country into a period of credit expansion that would terminate in panic and the utter collapse of our banking system."

Mr. Horace White had similar apprehensions. While the Federal Reserve Act was being debated in Congress Mr. White wrote: [5]

"The new banks are to be controlled by a board of seven persons at Washington city, only one of whom need be a banker or acquainted with banking science, and none of the appointees are to be selected by the bankers whose property they control. In other words, the control of bank property is separated from the ownership, contrary to all Anglo-Saxon precedents and customs. This is the system of the Imperial Bank of Germany with the difference that the latter is less liable to change of personnel of the bank directorate. That membership of the federal reserve board would eventually become a part of the spoils of politics, however free from that taint it might be in the beginning, all our experience shows. . . . There is serious danger that the passage of this bill may put an end to the national banking system, without giving birth to any other system."

Not all economists, however, felt so dubious. Kemmerer, for example, from the very beginning, felt that most of the foregoing criticisms were entirely unfounded. His address at this meeting of the Academy of Political Science shows that he was certain that the federal reserve system, if given a fair trial, would be successful.

Many prominent bankers frankly told the state institutions to wait. At the 1914 convention of the American Banker's Association this kind of advice was much in evidence. However, these bankers felt strongly that the delay should be only a temporary one, for they stated that the system would never operate to the highest degree of its efficiency until a large number of state institutions had be-

[5] White, Horace, *Money and Banking,* 4 ed. pp. 484–486.

come members. But not until the federal reserve banks had become more experienced and had shown the state institutions how the system would be operated, would it be the proper time for the state institutions to consider membership. It was at this meeting that Secretary Willis of the Federal Reserve Board stated that only the commercial banks were desired as members, but there were bankers present who disagreed with this statement.[6] Willis' statement that banks need not join to get the benefits of the system was frequently quoted to show that there need be no hurry on the part of state bankers to apply for membership.

At the 1915 convention of the American Banker's Association the opinion seemed to be prevalent that the federal reserve system was still untried, and that the state institutions should continue their policy of "watchful waiting." William A. Law, President of the American Bankers Association during 1915, said: [7] "The Federal reserve system has not yet been fully tested. The country still awaits the action of two most important factors in its operations, namely, the entry of the State banks as members and the removal of government deposits from the independent treasury. It cannot be questioned that all commercial banks, no matter where their charters are derived, together with the Secretary of the Treasury, should finally co-operate with the system if we are to co-ordinate all elements in our sphere of commercial finance."

Disparaging remarks concerning the federal reserve system were still frequent as late as 1916 in a number of quarters. The Journal of the American Bankers' Association, for example, was not at all friendly in its attitude during this period. It frequently gave vent to the opinion that there was no advantage to be derived from member-

[6] 40 Proceedings A. B. A., 1914. pp. 315–7. Remarks of Mr. W. E. Knox, Comptroller of Bowery Savings Bank, N. Y., and Mr. N. F. Hawley, Treasurer Farmers and Mechanics Savings Bank, Minneapolis.

[7] *41 Proceed. A. B. A., 1915, Com. and Fin. Chron.,* Sept. 18, 1915, p. 124–125.

ship. On one occasion it stated editorially:[8] "Bankers may be forgiven for withdrawing hearty support from a law which shows so many evidences of political insincerity in its making." Little friendliness for the federal reserve system was expressed by the various state banker's conventions during 1915 and 1916. For example, the President of the Iowa Bankers' Association said in 1916 that the state banks and savings banks would make a great mistake and bring calamity upon themselves if they joined the system. At this convention the editor of the Financial Age of New York told the bankers that the federal reserve system was "fundamentally unsound, structurally wrong, and impracticable in its operation." [9]

While the reluctant attitude of the state institutions may be explained broadly by indifference, conservatism (waiting attitude), or a failure to see any advantage in membership, there were certain specific reasons that were largely responsible for this feeling of aloofness. A number of these have already been mentioned. These objections to membership will now be discussed more fully under two groups: major objections, and minor objections.

Major Objections

I

To many bankers, the most deterring factor was a general distrust of the administration of the federal reserve system. Specifically, this included fear of political control, fear of dictatorial actions on the part of the Federal Reserve Board, dual state and federal supervision, interference by Comptroller of the Currency John Skelton Williams, red tape, and examinations. Mr. Frank Vanderlip, in 1916, expressed the opinion that fear of the type of control to be exerted over the member banks had been the

[8] *Journal A. B. A.*, August, 1916, pp. 98–99.

[9] Preston, Howard H., *History of Banking in Iowa*, Published by the State Historical Society of Iowa, Iowa City, 1922, pp. 206–210.

chief reason why the state institutions had not joined, but he added that he felt there was little ground for this opinion.[10] The President of the American Bankers' Association said in 1914,[11] "It is a just criticism of the measure to say that it does not take the government out of the banking business, and that it confers upon one of our government officials an extraordinary power and discretion, unwarranted by the spirit of our institutions and repugnant to republican principles." Mr. A. D. Welton, writing in 1916,[12] stated that it had been made reasonably clear that the larger state institutions had remained outside not because of any objection to the system itself, but because of objection to some matters of administration.

Apprehension was expressed that the regulations drafted by the Board governing membership of state institutions would be changed from time to time, since there was no requirement that they should be permanent. Although the right to withdraw and the power to exercise privileges granted by the state charters were expressly given, it was feared that these provisions might be changed by future decisions of the Board. Also, just how far the Board could go in the matter of making and enforcing its regulations was uncertain. This uncertainty was believed by Mr. Breckenridge Jones, President of the Mississippi Valley Trust Company of St. Louis, to have been the main reason why the state banks and trust companies had refused to join.[13]

Those who believed that the Federal Reserve Board would not use its powers wisely claimed that they received substantiation for their views from the so-called threats made by members of the Federal Reserve Board against the nonmember institutions. It was stated that the Board was

[10] 42 Proceed., A. B. A., 1916, p. 81.

[11] 40 Proceed., A. B. A., 1914, Com. and Fin. Chron. Supp., Oct. 24, 1914, p. 132.

[12] *Journal A. B. A.*, Oct. 1916, p. 292.

[13] Jones, Breckenridge, *Does the Federal Reserve System Need the State Banks*, Privately Printed, 1915, pp. 15–16.

trying to frighten the nonmember banks and trust companies into applying for membership by telling them that they could expect no help whatever in times of stress. Mr. Charles S. Hamlin, of the Board, made an address in November, 1915, before the Western Economic Society, in which he said that the state institutions should come in while they were welcome, that if they refused to join they would have to form a system of their own if they wanted assistance in emergencies, for when emergencies came they might not be received as members.[14]

It was further claimed that there would be a multiplicity of control. Those making this objection stated that the member state banks, and trust companies, would be supervised by the following authorities: The Federal Reserve Board, the officers of the federal reserve banks, the Secretary of the Treasury, the Comptroller of the Currency, and in addition to these the banking departments of their own state. They claimed that the banks could not tell where the authority of one left off and where that of another began. The Federal Advisory Council believed that this was one of the chief reasons why the state institutions did not join.[15]

The Federal Reserve Act as originally enacted prescribed that the state institutions were to make reports of their financial condition to the Comptroller of the Currency. This was exceedingly distasteful to the state bankers. Many of them feared that they would be subject to examinations made directly from the office of the Comptroller at Washington. Many of the state bankers had an intense dislike for Comptroller John Skelton Williams. They claimed that the fact that he would have power to compel reports from them was enough to keep them out of the system, regardless of any other provision of the Act. They claimed, furthermore, that he reciprocated their feel-

[14] This speech contained in Moulton, H. G., *Money and Banking*, Part II, p. 329.

[15] 5 Fed. Res. Board, 1918, p. 785.

ings and was possessed of a desire to persecute the state institutions. The Banking Commissioner of Wisconsin in an address delivered before a convention of the National Association of Supervisors of State Banks emphasized this distrust in the following words: [16]

"The Comptroller of the Currency has lost no opportunity to belittle the State banks, and the supervision of the State banks. He has by unfair comparison with the record of the National banks sought to create a public distrust of the State banks. This has not served to promote the taking of membership by such banks. Nor has the Comptroller's assertion, in official reports, that certain legislation recommended by him would bring about the nationalization of the State banks, served to create a more friendly feeling toward the Reserve System."

This feeling was also emphasized by Mr. John G. Reading, President of the Trust and Safe Deposit Company of Williamsport, Pennsylvania, at a meeting of the Pennsylvania Bankers' Association in May, 1916. Mr. Reading said: [17]

"It is impossible to serve two masters. You in the national system have a master. You know it; he makes you tired. We State banks also have masters, but they know something about the banking business and are not interested in finding out how many buttons you wear on your shirt."

It was also stated that member banks would be hopelessly entangled in governmental red tape, with a tremendous burden of reports and examinations. This criticism was heard in all of the districts.[18]

[16] Cousins, Marshall, *Desirability of State Bank Membership in the Federal Reserve System,* Privately Printed, p. 9.

[17] *Com. and Fin. Chron.,* May 27, 1916, p. 1957. The Amendments of June 21, 1917, remedied these objections by removing the state institutions from the Comptroller's jurisdiction.

[18] 2 Fed. Res. Board, 1915, p. 304.
3 Fed. Res. Board, 1916, p. 345.
Ibid., p. 395.
4 Fed. Res. Board, 1917, p. 414.

Many bankers protested against the procedure they had to follow to obtain a balance at the federal reserve bank by rediscounting. It was originally prescribed that a financial statement of the business man whose paper was to be rediscounted must accompany the application for rediscount. Many of the districts reported difficulty in securing these statements. This statement was not always required, however. Most of the districts reported that as time went on the opposition to preparing such statements gradually disappeared.[19] In some cases it was found that the requirement of reports of condition in this way resulted in sounder business practices. Gradually it came to be the custom not to require a statement with each and every rediscount. So long as the bank presenting the paper had such a statement and was possessed of enough knowledge of the standing of its customers to enable it to reach a sound decision as to his standing the purposes of the requirement were understood to have been fulfilled.

There were objections raised to the requirements for examinations. The Federal Reserve Board announced in the 1915 regulations that the examinations by state and federal authorities would be made simultaneously as far as possible. The examinations made by the state authorities were to be accepted wherever they were satisfactory. The state institutions feared however that some time must elapse before coöperation on this matter could be worked out between the state and federal authortiies. Meanwhile they would have to undergo duplicate examinations, entailing considerable expense and waste of time.

The Federal Reserve Board made an informal ruling on September 16, 1915, to the effect that where the call by the state banking department fell on the same date as the call of the Comptroller of the Currency, the state institution might simply mail a sworn duplicate of the report for the state authorities to the Comptroller, but if the calls fell

[19] 3 Fed. Res. Board, 1916, p. 317, and 4 Fed. Res. Board, 1917, p. 414.

on different dates the report for the Comptroller must be made in addition.[20] The Counsel of the Federal Reserve Board was asked to give an opinion as to whether it was obligatory on the member state institutions to make the same reports to the Comptroller as were made by the national banks. He decided that it was.[21] The state bank and trust company members must, he said, report to the Comptroller five times each year on forms prescribed by him. These reports had to be verified by the oath of the bank president or cashier and attested by the signature of at least three directors. A very detailed statement of resources and liabilities was required, and it was to be sent to the Comptroller's office within five days of the call and published in the nearest newspaper. Penalties for nonconformance were specified. The five extra reports were considered to be a nuisance by the state institutions since only occasionally would the Comptroller's call coincide with that of the state. It was, also objectionable because of the power it gave the Comptroller of the Currency over the state institutions.[22]

II

Many state bankers claimed that they had no need whatever for the facilities offered by the federal reserve system. They would still need to retain relations with their correspondents, and the rediscount privilege would be of little or no value. Joined with these contentions, was the fact of a general ease in the banking and credit situation.

These state bankers maintained that whether or not they became members of the federal reserve system it was either necessary or desirable for them to retain their relations with their reserve city or city correspondents. They asserted that the federal reserve system could give them

[20] Fed. Res. Bull., Oct. 1, 1915, p. 309.
[21] *Ibid.*, p. 319.
[22] This objection was remedied by the amendments of June 21, 1917.

nothing that they could not obtain from their correspondents, that in reality their correspondents were more efficient, more courteous, and considerate than the federal reserve banks. There was, therefore, no advantage to be derived from membership. Many of them claimed that their correspondents were able to collect checks for them much more quickly than it was being done by the reserve banks, that this service was done for them without charge, while at this time the federal reserve banks were making a small charge for so doing.

Many state banking institutions announced that they would receive all the benefits of membership through their national bank correspondents. Moreover, the banks were able to collect interest on their deposits with the correspondents, deposits, which in most states, could be counted as legal reserves. Membership in the system would ultimately lead to the transference of all reserves to the federal reserve banks. Some of the city correspondents, believing that they would lose these deposits if state banks maintaining them should join the system, advised them to stay out. A large proportion of the deposits were kept in the city banks to compensate the correspondent for the expense involved in the collection of checks for the country bank. It was seen that the development of the federal reserve check clearing and collection system would abolish the necessity for maintaining many of these deposits, which in most cases the city banks were eager to retain.

The nonmember banks claimed that they were able to borrow more cheaply and quickly from their correspondents than from the federal reserve banks. The federal reserve agent of Atlanta in his 1915 report stated that forty-nine member banks in that district were still borrowing from correspondents in New York or elsewhere, claiming that it involved less trouble, and that a more favorable rate could be obtained. The federal reserve agents of Boston and Dallas reported similar circumstances in their districts in 1916. Much of the continuation of the use of correspond-

ent banks was due to the fact that dealings with them were on a long-standing, easily-understood basis, while the possible relations with the federal reserve banks were not clearly comprehended. The state institutions claimed that they could not afford to keep non-interest bearing deposits with the federal reserve banks, as well as those with the correspondents.

Many of the city bankers, however, refused to worry over the probable loss of these deposits. They saw that if they no longer were the depositories of the country bankers they could enter into competition with them for much of their business. Some of the country bankers understood this and wished to keep the city banks as depositories in order to prevent competition. It is true that membership might not be profitable to those banks which insisted on keeping large deposits with their correspondents. One of the most beneficial aspects of the federal reserve system has been that it makes possible the withdrawing of deposits which were maintained solely for check collection purposes. Country banks used this relationship with their correspondents to collect at par checks on other banks and at the same time deducted exchange charges in remitting on their own checks returned for payment. On the other hand, it was not expected that all relations of members with correspondent banks would be destroyed by the establishment of the federal reserve system.

Another use of the city correspondent by the country bank has been mentioned by some authorities. It is claimed that many of the country bank officers are engaged at the same time in other businesses and that they borrow from their city correspondents for their private business affairs. They feared that entry into the system would necessitate the severing of relations with the city correspondent and that as a result they would be unable to obtain any more loans for private purposes. In other words, it is contended that the country banker has taken advantage of his of-

ficial relationship with the city bank to secure personal loans for his own business purposes.

It was also said that even if the state institutions joined they would find the rediscounting privilege of little value since many of them objected to rediscounting on principle, as an evidence of weakness; some of them never borrowed from anyone; and even if they desired to rediscount they had little or no eligible paper. One of the common prophecies made when the Glass-Owen Bill was under consideration was that the bankers of this country so thoroughly abhorred the idea of rediscounting that this function of the system would never be developed. It was frequently asserted that business men would object to having paper bearing their signatures rediscounted. Many of the prominent bankers carried on a campaign of education on this matter during 1913 and 1914 and early in 1915 several of the large banks in the Chicago district rediscounted merely to set an example.[23] Similar occurrences took place in other districts with beneficial results, some rediscounting being done to retire the Aldrich-Vreeland emergency currency.

The Federal Reserve Board in its annual report for 1915 discussed this problem as follows:[24]

> "It was a current remark when the Federal Reserve Act was under consideration that member banks would find but little of the kinds and maturities of paper made eligible for rediscount. Experience has shown the exaggerated character of this view. . . . Many banks who believed at the opening of the year that no considerable part of their paper would be available for rediscount, now recognize that a substantial proportion of it either is already eligible or may easily be made to comply with the provisions of the law."

The New York district reported to the Federal Reserve Board in 1915 that during that year many of the country bankers had claimed that they had no paper eligible for

[23] 2 Fed. Res. Board, 1915, p. 283.
[24] *Ibid.*, p. 10.

rediscount, so the officers of the federal reserve bank had consumed a great amount of time in explaining to these bankers what paper was eligible, for it was found that they had more than they realized.[25] This experience was duplicated in the Philadelphia district.[26] In both districts a strong prejudice against rediscounting was found. The Federal Reserve Bank of St. Louis reported,[27] "In some way or other many of the banks in this district got the idea that they had no paper eligible for rediscount, whereas the fact was that, in a majority of instances, the greater part of the paper in their portfolios was eligible."

The Federal Reserve Board has never insisted that a state institution should possess a certain amount of eligible paper before it could be admitted. In its annual report for 1916 the Board stated that the fact that a bank had little eligible paper should not keep it out of the system, for it could contract for loans and obtain cash from other member banks having such eligible paper and thus be accommodated indirectly.[28] The state bankers replied that they could do this even if they were not members.

There was some justification for the claim that the rediscounting privilege was of little value during the first two years of the system, for as a matter of fact there was very little rediscounting done owing to the ease in the financial situation. The largest amount of rediscounts held by the federal reserve banks during the first two years was $38,345,000 on December 8, 1916. By the end of the next year, however, the figure had increased to $437,930,000, showing that the claim that this privilege was of little value had lost much of its force.[29]

In some districts it has been difficult to persuade the business man to agree to the rediscounting of paper bearing his name at the federal reserve bank.

[25] *Ibid.*, pp. 160–161.
[26] *Ibid.*, pp. 219–220.
[27] *Ibid.*, p. 304.
[28] 3 Fed. Res. Board, 1916, p. 20.
[29] 4 Fed. Res. Board, 1917, p. 781.

Many country national and state bankers maintained that they would never rediscount, because they never needed assistance from another bank.

One reason, then, why there was no pressure to use the facilities of the system was because of the ease of credit conditions during 1914 and 1915. There was, in general, no urgent reason for them to use the facilities afforded by the federal reserve system for they could take care of the demands upon them without asking aid from other sources. In the Dallas district this was thought to have been a very important factor.[30] The federal reserve agent at Atlanta, in his annual report for 1915, stated that the state institutions could not be persuaded to join while money was easy.[31] In the same year the Federal Reserve Bank of San Francisco found that the state banks and trust companies had no need for the services of the federal reserve system, and so were in no hurry to join.[32] The federal reserve agent at Boston reported in 1916 that there was not much hope of increasing the list of member state banks and trust companies until a stringency developed in the money market.

Officials of the system and the members of the Federal Reserve Board tried to make these banks realize that it was dangerous to wait for stormy weather. When conditions changed so that there was a stringency, if the state institutions wished to join, they might find that they would not be quite so welcome, or the federal reserve banks might be so busy taking care of the members that there would be no time to consider new applications. The Federal Reserve Board in commenting upon the situation said: [33]

"Apprehension of stringent conditions or the development of any situation requiring mutual aid on the part of banks would undoubtedly cause many nonmember banks to apply for membership, but it is not believed that they will as a rule elect

[30] 3 Fed. Res. Board, 1916, p. 423.
[31] 2 Fed. Res. Board, 1915, p. 276.
[32] *Ibid.*, p. 364.
[33] 3 Fed. Res. Board, 1916, pp. 19–20.

to await such conditions. There is no reason why such assistance should not be freely given to a member State bank. While in time of stress the nonmember banks may find the member banks not less disposed but less able to give them this indirect assistance."

Such arguments, however, brought little results, except that the banks claimed that these statements showed that the Federal Reserve Board was trying to frighten or coerce the state institutions into membership.

III

One strong objection urged was that it was very doubtful whether the state institutions had the power to withdraw, should they become members. The Federal Advisory Council, late in 1914, believed that this was the greatest obstacle to membership.[34] Elsewhere it has been mentioned that this question gave the Federal Reserve Board more difficulty than any other problem connected with state bank and trust company membership. It was realized that permission to withdraw must be granted, so section VI of the 1915 regulations for state banks and trust companies expressly gave to state institutions the right to withdraw upon one years notice, provided that too many did not apply in any one year. In spite of the fact that the Board stated that this section of the regulations would not be changed except upon six months notice to the members, the banks were apprehensive because the right to withdraw was not expressly written in the law. The requirement of one year's notice and the limitation of the number which might withdraw in any one year to 10 per cent of the capital of the federal reserve bank was not satisfactory to the nonmembers. The state institutions feared that the regulations might be changed at some time in the future and that they would have trouble in securing the repayment of their paid-in capital and deposits should they decide to with-

[34] 5 Fed. Res. Board, 1918, p. 767.

draw. Furthermore, there was some question as to whether the Federal Reserve Board really possessed the authority to permit state institutions to withdraw.[35]

IV

The greatest cause for complaint on the part of banks and trust companies which were members of the system was the fact that no interest was paid on the reserves which were required to be deposited with the federal reserve bank. The reserve requirements compelled member banks in central reserve cities to keep an 18 per cent reserve against demand deposits, members in reserve cities to keep 15 per cent, all members in other cities to keep 12 per cent. All were to keep 5 per cent reserve against time deposits. Banks in central reserve cities were required to keep $7/18$ of their reserves in the federal reserve bank, $6/18$ in their own vaults and the *remainder either in the federal reserve bank or their own vaults.* Banks in reserve cities at first had to keep $3/15$ of the reserves in the federal reserve bank, increasing this amount semi-yearly for three years until $6/15$ had been placed there. Members in other cities at first had to keep $2/12$ of their reserves in the federal reserve banks, increasing this amount semi-yearly for three years until $5/12$ had been placed there. At the end of the three year period the amounts above specified had to be kept in the federal reserve banks. The remainder could be kept there also, but it might be retained in the vaults of the member institution. It could not be kept anywhere else, so this requirement necessitated the wholesale withdrawal of reserve deposits from banks in other cities by the end of the three year period.

These requirements excited much dissatisfaction. In the results of the nation wide investigation conducted by the Guaranty Trust Company of New York in 1916, this

[35] This objection was nullified by the amendments of June 21, 1917, to section 9, containing a provision writing into law permission to withdraw.

was by far the most important objection mentioned by the national bank members, and occupied an important position in the objections named by the nonmembers.[36] The annual reports of the federal reserve agents mention that there was a vast amount of complaint on this score.

The reason for the dissatisfaction among the bankers was that they had become accustomed to count their interest bearing deposits with correspondents as reserves. This was permitted by both the national banking act and state laws, and upon these deposits they were paid interest of from 2 to 3 per cent. Interest earning reserves had been the custom for years in American banking practice, so that the bankers felt that in not receiving interest on their deposits with the federal reserve banks they were being robbed of something which was rightfully theirs by long established practice.

That the actual loss to national banks was very great may be seriously questioned. Required reserves against time deposits were reduced to 5 per cent. Reserves against demand deposits were also greatly reduced. A wise investment of the funds thus released would have brought in earnings which would have gone far to offset the loss from non-payment of interest. The country national banks, however, had a basis for complaint since their reserves had been reduced less proportionately. The possibility of a net loss was greater for them, for previously they had not been required to keep more than 6 per cent of the reserves in their own vaults. The other 9 per cent could be kept in interest bearing deposits in other banks.

The attitude of the national bankers on this question was well known to the state institutions and they echoed the sentiments vigorously. A survey of the state laws reveals the fact that while the average reserve required of the state institutions at this time was about 15 per cent

[36] Guaranty Trust Company of New York, What the Banks of the United States Think of the Federal Reserve Act, Privately Printed.

of demand deposits, and 5 per cent of time deposits, the average vault reserve was about one-third or two-fifths of this amount. This meant that only from 5 to 6 per cent of the deposits actually had to be kept in the bank itself, while the remainder could be kept in other banks drawing from 2 to 3 per cent interest. A number of states required no definite vault reserve whatever.[37] Some states, as for example, Connecticut, Massachusetts, and Pennsylvania, allowed a portion of the reserve to be invested in state or government bonds. In view of these facts it must be admitted that the original requirements resulted in a net loss to certain member state institutions, for at the end of three years they would have been losing interest upon 12, 15, or 18 per cent of their deposits, depending upon their location. In some particular cases the possibility of loss was small, but if the member institution insisted on retaining the same deposits as before with their correspondents, the loss might have been considerable. Some banks had always carried a specie reserve larger than that legally required. After these banks became members they could carry a much smaller amount in their vaults, because if they needed assistance they could get it quickly by rediscounting at the federal reserve bank. The vault reserve released could be invested at a profit. An example of this kind is found in the following statement of the president of an Iowa bank:

> "We lose the interest on our reserve balances, which will amount to approximately $3,000 a year. I estimate that by taking the surplus reserve we now deem it necessary to have, and investing it in commercial paper, we can make up without any difficulty the loss of interest on the balances we now carry with our reserve correspondents. We usually have a surplus reserve of approximately $200,000. If we take $150,000 of that it is safe to assume that we can invest it in commercial paper, pay-

[37] See state reserve requirements compiled in 2 Fed. Res. Board, 1915, pp. 104–113; also revised tabulation in Fed. Res. Bull., Oct. 1, 1917, pp. 768–795.

ing an average rate of 4 per cent, thus making a profit of 2 per cent over the interest paid us by banks. That $3,000 will take care of the loss on the reserve balance carried in the Federal Reserve bank."[38]

There were a number of statements to the effect that member state institutions would not be able to increase their lending power upon joining. The Tennessee Banker's Association took the position that membership had brought no such advantage and stated with regard to the member banks in that state:[39]

> "Their loaning power has been decreased accordingly; they have not been able to increase their loans because of the lessening of the reserve requirements, finding it necessary to keep in their vaults about the same amount of money they have always kept, maintain the same collection facilities they have always maintained, and to keep about the same balances with their city correspondents they have always kept."

Aside from the fact that it is wrong in banking theory to advocate interest bearing reserves, the federal reserve banks could not have paid any interest during the first two years of their existence, for many of them did not even pay the 6 per cent dividends in full.

It was frequently stated during the first years of the system that enough reserve had been paid in to maintain the federal banks indefinitely. It was argued that if the law could be changed to permit new members to join without paying in any part of the required subscription there would be a large increase in membership. This would probably have been true, but it would have been most unfair to those already members. Some suggestions contemplated a partial repayment of the capital and reserves already paid in. Andrew J. Frame, a banker of Waukesha, Wisconsin, was among those who championed this argument. The Bankers' Magazine of New York published in

[38] *Journal, A. B. A.*, Feb. 1, 1917, p. 693.
[39] *Journal, A. B. A.*, Jan. 1916, p. 598.

May, 1916, some remarks by Mr. Frame on "Why Some State Bankers do not Join the Federal Reserve System," with the following caustic comments on the system:[40]

> "The conclusion to which Mr. Frame's statement leads is that the national banks have been forced to yield up a huge sum of money to the Federal Reserve system for which they have received no substantial return. In view of this fact it can hardly be expected that the state banks, which are exempt from the bludgeons of Federal statutes shall surrender a large share of their capital and deposits to an ornamental political board at Washington merely for the purpose of enhancing the emoluments and prestige of the distinguished superfluities who have been endowed by the Federal Reserve Act with the control of the national banking system."

The Tennessee Bankers' Association in 1915 argued that the capital subscription and reserve requirements were too large, and recommended that the law be changed so that only 1 per cent of the capital of the member bank, leaving the surplus out of consideration, should be paid in to the federal reserve banks. Another recommendation was that the balance of the reserves which was to be ultimately removed from correspondent banks to the federal reserve banks should be allowed to remain either in the vaults of the member banks or with reserve agents in reserve or central reserve cities.[41]

The American Bankers' Association recommended that the country member banks be permitted at the end of the three year period to keep 3 of the required 12 per cent of their reserves in a reserve city member bank in the same federal reserve district, or within a radius of three hundred miles of the place where the country bank was located. Bills to make this possible were introduced by Senator Pomerene and Congressman McFadden, but could not obtain favorable reports from the Congressional Commit-

[40] *The Banker's Magazine,* New York, May, 1916, p. 598.
[41] *Journal, A. B. A.,* Jan., 1916, pp. 598–599.

tees.[42] There was so much objection to this measure that finally the Association ceased to urge its adoption and centered its attention upon obtaining a reduction in the total reserve requirements.[43]

When it was seen that membership in the system might permit a state institution to carry lower reserves against deposits, some of the states began to lower their reserve requirements so that the banks and trust companies which did not care to enter the federal reserve system would not be at a disadvantage.[44] Some of the states whose reserve requirements were lowered after the passage of the Federal Reserve Act were Connecticut, Kansas, Kentucky, New York, Oklahoma, Oregon, Texas, Virginia, and Wisconsin.[45] The Federal Reserve Board, in its annual report for 1915, severely criticised this practice, stating that it would be a source of financial weakness. The only justification for so doing, it argued, would be membership in the system, but nonmembers which were permitted to reduce their reserves would be more vulnerable than ever in times of emergency. The Board expressed the hope that this would not mark a beginning of an attempt by the states to make competition with member banks more favorable to the state chartered institutions.[46]

V

It was charged that the system was drawn up for national banks and to take care of the type of business done by national banks, that it was poorly adapted to the

[42] This attempt to obtain permission to retain a portion of the reserves was condemned by the federal reserve agent of New York as being contrary to the whole spirit and intent of the Federal Reserve Act. 2 Fed. Res. Board, 1915, p. 180.

[43] The attempt to secure a reduction in the reserve requirements was successful. The amendments of June 21, 1917, reduced reserves against demand deposits to 7, 10, and 13 per cent for country banks, banks in reserve cities, and central reserve cities, respectively. Reserves against time deposits were reduced from 5 to 3 per cent.

[44] 2 Fed. Res. Board, 1915, pp. 104–113.

[45] Ibid.

[46] *Ibid*, pp. 13–14.

needs of the state institutions. It was claimed that the state banking institutions had received little consideration during the preparation and passage of the Federal Reserve Act. The investigation of the Guaranty Trust Company of New York showed that many state banks and trust companies held this belief. But it has been shown that the needs of the state institutions received attention, that their membership was desired, and that the act was framed not so much to take care of only the national banks as to create a sound banking system which any bank of sufficient size and soundness might enter to its advantage.

The decision of the counsel of the Federal Reserve Board that state institutions could not be government depositories, even though members of the system, gave the state institutions some basis for claiming that the national banks had the preference. This decision was the cause of much dissatisfaction.[47]

VI

An important objection raised by the state institutions was that it was doubtful whether the federal reserve banks could pay the prescribed dividends of 6 per cent on the stock held by member banks. This fact they said, joined with the loss of interest on their reserves, made membership too expensive for them.

The fact that dividends were cumulative until paid did not quiet these complaints. Many bankers said it would take years before the federal reserve banks could catch up on the payments. For a while it looked as though there was considerable truth in such statements. Total earnings of the system in 1915 were only slightly over $600,000,[48] and in 1916 they were $2,751,000, (about 5 per cent on the average capital stock for the year), so that by the beginning of 1917, although the earnings were increas-

[47] 5 Fed. Res. Board, 1918, p. 782. See note 34, Chapter IV.
[48] 2 Fed. Res. Board, 1915, p. 90.

ing and dividends were being paid, the payments were still considerably behind.[49] Even by the end of 1917, with net earnings of over $11,000,000 for that year, only six reserve banks had caught up with their payments. These banks were New York, Boston, Richmond, Atlanta, Chicago, and Minneapolis. The Banks of Philadelphia, Kansas City, Cleveland, and Dallas had earned enough to pay dividends up to June 30, 1917, but St. Louis and San Francisco could complete dividend payments only up to December 31, 1916.

There is however, no further difficulty on this score, as dividends in arrears have long since been paid.

VII

The restrictions placed by the Federal Reserve Act upon bank loans was considered by many state banks and trust companies to make membership disadvantageous. Under section 5200 of the United States Revised Statutes which was made applicable in section 9 of the Federal Reserve Act to all member banks, no member bank could lend to any one person, firm, or corporation an amount greater than 10 per cent of the lending bank's capital and surplus. This would have been disadvantageous for many state institutions which sometimes exceeded this limit.

Some state institutions complained that the Federal Reserve Act limited loans on farm lands to 25 per cent of the lending bank's capital and surplus. This was a misconception and showed ignorance of the law. This restriction, which appears in section 24 of the Act, prohibited such loans with maturities greater than five years. No loan was to be greater than 50 per cent of the value of the land. The total loans of this kind made by a bank were not to exceed 25 per cent of its capital and surplus or one third of its time deposits. But this restriction applied only to national bank members. The only restriction on loans of this character by state institutions appeared in Section

[49] 3 Fed. Res. Board, 1916, p. 13.

V of the 1915 regulations which merely stated that state bank and trust company members could invest in loans on real estate or mortgages to an extent which still enabled the institutions to maintain their liquidity and meet their obligations.[50] Yet the investigation of the Guaranty Trust Company revealed that even in 1916 there were 236 banks which mentioned this as an obstacle to membership of state institutions. This misunderstanding, it must be remarked, is similar to many other misconceptions of the Federal Reserve Act.

VIII

Many of the state banks and trust companies feared that they would lose valuable rights granted to them by their state charters should they enter. The Federal Reserve Board endeavored to alleviate this doubt by stating in section V of the 1915 regulations that these rights would not be interfered with except as they were contrary to the Federal Reserve Act and the regulations of the Board. If, however, the examination preliminary to admission revealed that the bank possessed corporate powers which the Board considered to be undesirable from the standpoint of sound banking principles the bank or trust company might be permitted to enter only on conditions laid by the Board. In its 1916 report the Board stated that it might consider that the power to exercise certain prerogatives in the way of corporate activities might make an institution an undesirable member, and its application might be refused. But, after a bank had once been admitted the Board did not expect to interfere with the exercise of the banking and fiduciary powers authorized by its charter. The Board did not expect to interfere nor feel it to be one

[50] The importance to state institutions of the power to lend on real estate is shown by statistics taken from the special reports of the banks of the United States to the National Monetary Commission in 1909. The state banks had lent $414,000,000 or 12½ per cent of their resources on this type of security. Trust companies had loans outstanding on real estate to the amount of $377,000,000 or about 9 per cent of their resources.

of its functions to restrict the state institutions in the exercise of banking or trust powers as defined by the states where the institutions were located.[51] But the nonmember banks and trust companies felt that such statements were too general and might not give protection in particular cases. In addition, there was no guaranty that the regulations would not be changed.[52]

IX

It was impossible for many banks to join because laws in many states wer,la''favorable to membership. Some states did not permit,ns th. institutions to subscribe to the stock of the federal rethey e banks. Some states had rigid requirements as to whela reserves should be kept. This would have prevent of the ite institutions from depositing reserves with the plicabl reserve banks. Certain states prohibited the divuiber of information, which would have been necessary fo firm, is to the federal reserve banks, to other than state the ls. Some attorney-generals ruled that membership been dot legal without a change in the state law. This sometim is believed by Reed to have been the main reason stitutio few state institutions joined at first.[53] It was state loar July, 1914, that there were at that time only twenty stapis in which no modification of the state laws was necessary before state institutions could join.[54] Wholesale changes were necessary and the state

[51] 3 Fed. Res. Board, 1916, pp. 20–21.

[52] This objection was largely nullified by the amendment of June 21, 1917, to section 9 of the Act which definitely wrote into the law permission to retain state charter and statutory r'ghts.

[53] Reed, Harold L., *The Deve'l ment of Federal Reserve Policy,* p. 55.

[54] These states were listed as Vermont, New York, New Jersey, Delaware, Maryland, Virginia, West Virginia, Kentucky, Tennessee, Ohio, Indiana, Illinois, South Carolina, Alabama, Mississippi, Arkansas, Texas, California, and Oregon.

legislatures seemed to be willing to make the amendments.[55] Most of the original laws were defective in that while they gave permission to enter the system, they did not permit the state institutions to substitute the federal reserve requirements for those required by state law so that the total reserve carried by members would have been larger than before. This privilege was soon granted by the majority of the states. Later, the Federal Reserve Board and the American Bankers' Association agreed upon a complete law making full provision for all the difficulties encountered by the conflict of laws, and many states passed this law.

Minor Objections

I

Those clauses in sections 13 and 16 of the Federal Reserve Act providing for the clearing and collection of checks excited both favorable and unfavorable comment. It will be remembered that those banks which first joined the system were almost equally divided as to the merits of par collection of checks. The investigation of the Guaranty Trust Company of New York also revealed a considerable difference of opinion.

Some bankers who favored the extension of the col-

[55] In 1914, Massachusetts, Kentucky, Louisiana, New Jersey, Ohio, Virginia, New York, South Carolina, and Texas gave permission to institutions in those states to join. The next year California, Idaho, Delaware, Iowa, Kansas, Maine, Michigan, Minnesota, Missouri, Montana, Nebraska, New Mexico, North Dakota, Oregon, South Dakota, and Washington followed suit. *The Federal Reserve Bulletin of September 1, 1915*, p. 263, does not include Delaware and Kansas in its list of changes during 1915, but does include Mississippi and Utah which were omitted in the list cited above. In 1915 state authorities ruled that it was no violation of state law to subscribe to stock in the federal reserve bank in the following states: Alabama, Arizona, Arkansas, Georgia, Illinois, Indiana, Maryland, North Carolina, Rhode Island, Tennessee, Vermont, West Virginia, and Wisconsin. Federal Reserve Bulletin, August 1, 1915, p. 182. For examples of the amendments passed see *Fed. Res. Bull.*, July 1, 1915, pp. 150–156, containing the laws passed by Idaho, Indiana, Iowa, Kentucky, Massachusetts, Maine, New Jersey, New York, North Dakota, Texas, Utah, Virginia, and Washington.

lection system were not certain as to how far the federal reserve system might go. Many of them feared that it might still be necessary for them to retain their deposits with city correspondents for collection purposes because the federal reserve plan might not be extensive enough to clear and collect checks on all other banks. If the system, for example, decided not to clear and collect checks on nonmembers it would be necessary for members to rely on their correspondents for this service. This would make membership expensive because of the additional deposits necessary to compensate the correspondents for doing the work, and of the fact that no interest was paid on the reserve deposits at the federal reserve bank. Where the deposits with the correspondents could not be withdrawn to some extent upon joining the system, and reinvested to bring a larger return, this loss might be considerable.

The first collection system developed by the federal reserve banks in 1915, was purely voluntary, but it was so unsatisfactory that it was abandoned. A compulsory plan for all members went into effect in July, 1916. It was not until it was known that a compulsory plan was contemplated that protests began to be vehement. The sentiment of the country bankers in New York State was shown to be strongly against this movement,[56] and it became a serious factor retarding the movement of the state institutions into the federal reserve system. A number of the country national banks threatened to give up their national charters and withdraw when compulsion began, but their threats were never carried into effect to any large degree. It was not until later, when the federal reserve system tried to collect at par all checks, whether on members or nonmembers, that the animosity of the state institutions became so bitter. The history and present status of the par clearing movement is treated more extensively elsewhere in this volume.[57]

[56] *Journal, A. B. A.*, May, 1916, p. 992.
[57] See Chapter XIII and XIV.

II

Ignorance and misunderstanding of the Federal Reserve Act and the operation of the federal reserve system on the part of state bankers and trust company officers all over the country was very evident and was responsible for many imaginary obstacles to membership. The officers of the federal reserve banks and the members of the Federal Reserve Board labored to their utmost capacity to dispel many of the illusions of the bankers. The federal reserve agent at St. Louis complained that even many of the member banks would not read the circulars of information distributed by the federal reserve bank and would frequently ask foolish questions that even the most casual perusal of the circulars would have rendered unnecessary.[58] Similar situations existed in many of the other districts. It might be added that even to-day there is much ignorance among bankers regarding the purposes and operation of the federal reserve system.

III

Objections were raised to the effect of Section 6 of the Clayton Anti-Trust Act on state institutions. This act stated that after October 15, 1916, no person could be, at the same time, director or any other officer or employee of more than one bank or trust company organized or operating under federal law, where either bank had deposits, capital, surplus, and undivided profits aggregating more than $5,000,000. It also prohibited any private banker or director of any state bank or trust company, having capital, deposits, surplus, and undivided profits of over $5,000,000, from being a director in any bank operating under the laws of the United States. In cities of 200,000 or more inhabitants, no bank or trust company operating under the national law could have as a director, officer, or employee, any private banker, or director, officer, or employee of any

[58] 3 Fed. Res. Board, 1916, p. 345.

other bank or trust company located in the same place. The Act did not apply to mutual savings banks. It did permit a director, officer, or employee of a bank or trust company operating under federal law in cities of over 200,000 inhabitants to be a director, officer, or employee of one other bank or trust company where the entire capital stock of one bank or trust company was owned by the stockholders of the other.

The American Bankers' Association had opposed this section of the Clayton Act and had succeeded at one stage in its legislative career in having it eliminated. But it was replaced with some modifications in the act as finally passed.[59]

Some of the larger state institutions believed that under this Act they would be forced to lose many of their most valuable directors should they enter the federal reserve system, and undoubtedly their fears were well grounded. While the restriction was not to be in effect until 1916, the banks saw no reason to join if entry would be disadvantageous ultimately in this respect. The Federal Reserve Board was called upon almost immediately for a number of interpretations of the Clayton Act as it affected the member institutions. It was doubted whether the provisions of the act applied to state institutions. The question was whether they were "organized *or* operating under the laws of the United States." The counsel of the Board believed that this phrase included the state institutions for the reason that in an early draft of the measure the words "organized *or* operating" had read "organized *and* operating." The change he said, signified an intention to cover state bank and trust company members.[60] In its annual report for 1916 the Federal Reserve Board mentioned the fact that this was an obstacle to the membership of some of the larger state institutions.[61] Special Instruc-

[59] *Com. and Fin. Chron. Supp.*, Oct. 24, 1914, pp. 121 and 125.
[60] Fed. Res. Bull., Aug. 1, 1915, pp. 223–224.
[61] 3 Fed. Res. Board, 1916, p. 19.

tions Number I of 1916 showed that the Board intended to put the prohibition into effect after October 15 of that year and that the state bank and trust company members were also to obey the restrictions.[62]

An early effort was made to modify the severity of the terms of the law in this respect. The Kern Amendment of May 15, 1916, relieved the situation somewhat. It provided that nothing in the Clayton Anti-Trust Act should prohibit any officer, director, or employee of any member bank or trust company, or a Class A director of a federal reserve bank, with the consent of the Federal Reserve Board, from being an officer, director or employee of not more than two other banks or trust companies whether organized under state or federal law if the banks or trust companies were not in *substantial competition* with the member bank.[63] The next difficulty was to determine what was meant by the words "substantial competition." The Board tried to be liberal in its interpretation and decided that the language of the amendment allowed a person, already permitted by the original Clayton Act to be a director, officer, or employee in two banks, to hold the same position in two other non-competing banks, four in all. This gave considerable relief. During 1916 the Board received 1,359 applications for such permission and approved all except 144 of them.[64] The fairness of these decisions was such that there was little objection. In deciding whether "substantial competition" existed the Board announced that no fixed rule could be laid down, that the facts in each case must be carefully determined, and that some of the points to be considered were the geographical territory covered, whether the banks did the same kind of business with the same class of customers, and size.

Objection on the part of the state institutions was not completely removed until the Acting Attorney-General of

[62] *Ibid.*, p. 148.
[63] Fed. Res. Act, amended to July 1, 1922, p. 55.
[64] 3 Fed. Res. Board, 1916, p. 18.

the United States, Mr. John W. Davis, rendered a decision on September 10, 1917, that the Clayton Anti-Trust Act, after the amendments of June 21, 1917, no longer applied to state institutions who might enter the system. While the phrase "organized or operating under the laws of the United States" included state institutions, yet he stated the amendments of June 21, 1917, gave power to the state institutions to retain their full charter and statutory rights and among these rights was clearly the power to select freely their own directors and officers.[65]

IV

A part of section 22 of the Federal Reserve Act was considered by some state banks to be an obstacle to membership. It provided in part:

> "Other than the usual salary or director's fee paid to any officer, or employee of a member bank and other than a reasonable fee paid by said bank to such officer, director, or employee for services rendered to such bank, no officer, director, employee, or attorney of a member bank shall be a beneficiary of or receive, directly or indirectly, any fee, commission, gift, or other consideration for or in connection with any transaction or business of the bank."

This section aroused much controversy. One purpose for which it was passed was to prevent directors and other officers from making money by borrowing money from the bank with which they were connected and relending the funds at a higher rate to some other person. It was claimed that some directors made it a practice to charge a commission for obtaining loans.[66] It was further charged that a director would use his position to make the bank buy securi-

[65] Fed. Res. Bull., Oct. 1, 1917, pp. 744–746.

[66] Jones, Breckenridge, *A Further Discussion of State Banks and Trust Companies entering the Federal Reserve System*. An address delivered before the Convention of the State Bankers of Kansas in 1918, Privately Printed, pp. 11–28.

ties or property in which he was interested, or to buy from the bank securities or property at a favorable price.[67]

It was believed by some bankers that a strict interpretation of this section would prevent a director from receiving interest on his deposits with the bank. It was also feared that it might be construed to prevent a director's borrowing from his bank. If he was a broker, his business might be seriously hampered. Some bankers claimed that the corporations in which the bank director was interested would not be able to borrow from the bank, but others thought that this was too severe an interpretation. Meanwhile, the Federal Reserve Board received many requests for an interpretation of the law.

Early in 1915 the counsel of the Board rendered an opinion which was rather indefinite and not at all satisfactory. The counsel stated that no ruling or interpretation of the Federal Reserve Board could protect a person who was subsequently indicted by a federal grand jury for violating the law. He admitted that there was great diversity of opinion as to the proper interpretation of section 22. He endeavored to give a definition to the expression "services rendered." Compensation, he said, might be paid for services rendered in an official capacity, or for services rendered to the bank in a transaction where a bonafide consideration accrued to the bank, a transaction in which it was proper for such a director, officer, or employee to take part. The fact that some consideration might be derived by the bank was not in itself sufficient, for the consideration to the bank might be too small and that to the director too large for the services rendered. Finally, stated the counsel, the director should get no compensation from a third party for services rendered in an official capacity between the third party and the bank.[68] But this opinion did not clear up the question to any extent. Furthermore, there was no guaranty that the opinion of the counsel

[67] *Ibid.*, p. 18–19.
[68] Fed. Res. Bull., May 1, 1915, pp. 16–18.

would be upheld by the courts should the bankers act on his advice. The reason that the bankers were so particular over the interpretation of this section was that very heavy penalties had been specified for infraction of its terms.

In its annual report for 1916 the Federal Reserve Board mentioned section 22 as one of the reasons why some state institutions did not join.[69] It recommended an amendment which would permit a director, officer, employee, or attorney to receive the same interest on their deposits as was paid to other depositors. It was also recommended that, subject to the affirmative vote or the written consent of at least three-fourths of the board of directors of the bank, notes, drafts, and bills of exchange executed or indorsed by a director or attorney of a member bank should be permitted to be discounted with the member bank upon the same conditions as other notes, drafts, and bills of exchange. The Board also wished the law to be changed so that directors and attorneys who were not officers or employees could receive the customary commissions or fees for services rendered in buying or selling securities or other investments for or on account of the bank. An amendment somewhat modifying that recommended by the Federal Reserve Board was passed on June 21, 1917, but even this was not satisfactory and another amendment was necessary. It was made on Sept. 26, 1918, and seems to have removed the objection.[70]

V

The trust companies objected most strenuously to the provisions of section 11, paragraph k, of the Federal Reserve Act, which gave to the Federal Reserve Board power "To grant by special permit to national banks applying therefor, when not in contravention of state or local law, the right to act as trustee, executor, administrator, or regis-

[69] 3 Fed. Res. Board, 1916, p. 19.
[70] *Ibid*, p. 144.

trar of stocks and bonds under such rules and regulations as the said board may prescribe." This was considered by the trust companies to be an unwarranted encroachment upon their rights, and they early declared this clause to be unconstitutional, and took measures to test its legality. Suits were begun in two states, Illinois and Michigan, as early as 1915. The Michigan case was carried to the United States Supreme Court and on June 11, 1917, the court handed down an opinion affirming the constitutionality of the section. While the extension to national banks of the right to exercise fiduciary powers was not an important obstacle to the membership of the trust companies, yet it stirred up considerable hostility among them toward the federal reserve system, partly because it was feared that it meant that the national government would gradually endeavor to gain some kind of control over the exercising of fiduciary powers throughout the country. It doubtless put some trust companies in a frame of mind where they were not desirous of membership in a system which so intruded in their sphere of business.[71]

VI

Many objections were raised to the way the country had been divided into districts by the Federal Reserve Bank Organization Committee. It was claimed that this committee had even violated the law in determining the boundary lines in that they did not consider the convenience and customary course of business of the banks.[72] Some state banks and trust companies believed that membership in a certain district in which they felt they did not belong might bring about changes in their relations with banks in

[71] For a more detailed treatment of this question see Tippetts, C. S., Fiduciary Powers of National Banks, American Economic Review, September, 1925, pp. 417–434.

[72] Cousins, Marshall, Desirability of State Bank Membership, pp. 8–10.

other districts, and they did not desire these relations to be interfered with.

VII

Some fear was expressed at first that the stockholders of member state institutions would, like stockholders, of national banks, be doubly liable in case of insolvency. But an opinion of the counsel of the Federal Reserve Board in September, 1915, held that only national banks were subject to this penalty unless the state law provided double liability.[73] However, double liability did exist with regard to stock subscriptions to the federal reserve banks.

VIII

The provisions regarding acceptances caused some objection. Mr. Breckenridge Jones, President of the Mississippi Valley Trust Company of St. Louis, stated that the limitation in section 13, that a member bank or trust company might accept drafts and bills of exchange drawn on it only up to 50 per cent of its paid-up capital and surplus, was largely responsible for keeping out of the system for a while one of New York's leading trust companies, which handles the foreign bills for about one half of the exported cotton crop of the United States.[74] The amendment of March 3, 1915, gave relief in this situation by giving the Federal Reserve Board power, at its discretion, to grant to banks applying for it the privilege of accepting up to 100 per cent of their capital and surplus. But when on September 7, 1916, this section was amended again, the clause giving this permission was accidentally struck out and had to be replaced by another amendment.

There was some controversy over the propriety of the purchasing by federal reserve banks acceptances of non-

[73] *Fed. Res. Bull.*, Sept. 1, 1915, p. 273.

[74] Jones, Breckenridge, *Does the Federal Reserve System Need the State Banks?* Privately printed, 1915, pp. 25-29.

member banks. Early in 1915 the Federal Advisory Council recommended that the reserve banks should not buy any acceptances that did not bear the indorsement of a member bank.[75] Some states, before the passage of the Federal Reserve Act, had authorized state institutions to accept bills of exchange drawn on them, and in some cases no limit was placed on the amount which might be so accepted. The Federal Reserve Board finally decided to allow the federal reserve banks to purchase the acceptances of the nonmember institutions. The Federal Reserve Bank of New York decided in 1915 to buy any good acceptances, whether of members or nonmembers. It reasoned that if it limited these purchases to members all the business would be driven to them, but the nonmembers were helping to develop the acceptance market and the increase in the acceptance business would help the banks more in the long run if it was not restricted to members.[76] While the acceptances of nonmembers were freely purchased, those of members early came to bear a more favorable rate.[77] Outside of the New York district there was not the same free purchasing of nonmember bank acceptances.

It is interesting to note the proportion of member to nonmember bank acceptances held by the federal reserve system during the first year. On March 31, 1915, out of a total of $10,906,000 of bank acceptances held by all the federal reserve banks, only $3,075,000 were those of member banks. By December 27 of that year the proportion had changed so that out of $20,599,000 of acceptances held, $13,790,000 were those of member banks.[78]

IX

Another source of criticism had to do with the open market operations of the federal reserve banks. There was some opposition to the granting of these powers when the

[75] 5 Fed. Res. Board, 1918, p. 767.
[76] 2 Fed. Res. Board, 1915, p. 166.
[77] 3 Fed. Res. Board, 1916, p. 228.
[78] 2 Fed. Res. Board, 1915, p. 48.

law was under consideration in Congress because it was feared that the federal reserve banks would enter into competition with their members.

During 1915 and 1916 when the federal reserve banks were depending on purchases of paper in the open market for a large part of their earnings considerable uneasiness developed. Nonmember banks claimed that they would not subscribe to the stock of the federal reserve banks if they continued to compete with members in this manner. But this did not lead the federal reserve banks to cease their activities in this respect. In 1916, 31.5 per cent of the earnings of the system came from acceptances bought in the open market, 22.3 per cent from United States Bonds and Treasury notes, 20.7 per cent from bills discounted, and 14.3 per cent from municipal warrants.[79] The Federal Reserve agent at Kansas City complained that at first the bankers objected because the federal reserve banks would not pay dividends, but as their earning power developed through purchases in the open market then the bankers became alarmed on that score and protested because the federal reserve banks were competing with them.

Summary

While indifference, conservatism, and inability to see any advantage from membership may explain the reluctance of banks to apply for membership, it must be remembered that these reasons were based on one or more of the specific objections which have been discussed.[80]

It may be concluded that there was sufficient validity in these objections to justify the majority of the state in-

[79] 3 Fed. Res. Board, 1916, p. 116.

[80] A summary of the results of the investigation of the Guaranty Trust Company may give some information regarding the strength of the various objections. Replies were received from 5,344 banks of whom 2,709 were national and 2,635 were state banks and trust companies. About 60 per cent of the member banks held favorable opinions regarding the federal reserve system. While many state institutions felt favorably inclined to membership, over half of them were noncommittal. The popu-

(Continued on Next Page)

stitutions in desiring to postpone entry into the federal reserve system.

The specific objections which have been outlined are:

Major Objections

1. Distrust of the administration of the federal reserve system.
   A. Fear of political influence.
   B. Dual state and federal control.
   C. Autocratic supervision by the Federal Reserve Board.
   D. Dislike of the Comptroller of the Currency.
   E. Red tape.
   F. Too many and costly reports and examinations.
2. No need for facilities offered by the Federal Reserve System. No advantage in joining.
   A. Necessary or desirable to retain relations with correspondents.
   B. Rediscount privileges of little or no value.
   C. Many state institutions never borrowed from other banks.
   D. General ease in credit situation during 1914 and 1915.
   E. Could receive benefits of system without joining.

larity of the law was greatest in the South and the Northwest, while it was most unpopular in certain parts of the East and Middlewest.

A list of objections named by the national banks and the number naming each objection follows:

Interest wanted on deposits	903
Have no dealings with federal reserve banks	699
Lack of full dividends on stock	624
Must still retain correspondents	598
Don't see why state banks should join	376
System too expensive	326
Too much red tape in rediscounting	312
Federal reserve capital too large	292
System of no value to country banks	257
Rediscount privilege of little value	243
System of little value to country banks	227
Proportion of reserve required to be in federal reserve bank too large	218
Too many federal reserve banks	190
Dissatisfaction with present Comptroller	159

Many others mentioned the requirements for reports, and the political aspects of the system. The banks were asked to make suggestions, but their replies to this were unsatisfactory. For instance, 262 national banks

(Continued on Next Page)

3. Fear of inability to withdraw from system should a bank so desire.
4. Non-payment of interest on reserves deposited in federal reserve banks. Reserve requirements too large.
5. System not adapted to needs of state institutions. For national banks only.
6. Lack of probability of dividends on stock of federal reserve bank held by member banks.
7. Various restrictions on loans laid down by Federal Reserve Act.
8. Fear of loss of certain state charter and statutory powers.
9. State laws unfavorable to membership of state institutions chartered in those states.

Minor Objections

1. Possibility of clearing and collection provisions of the Fed-

thought that clearings and collections should be left to the banks to manage, while 256 thought that this system should be even more comprehensive.

The 2,635 replies of the nonmember banks are summarized below:

See no advantage in joining	807
Bank was not interested	527
Watchfully waiting	393
More advantageous to retain correspondents	383
System poorly adapted to needs of state banks and trust companies	303
Non-payment of interest on reserves	284
Rediscount privilege of little value	275
Red Tape	263
Expense and inconvenience of many examinations	243
Probable lack of dividends	239
Limitation of farm loans to 25 per cent of capital	236
Other restrictions on loans	225
Dual supervision by national and state officials	163
Expense of too many reports	159
Dislike of Comptroller of the Currency	143
Can get benefits through correspondents	133
Political aspects of the system	127
Maturity of eligible paper unsatisfactory	108
Federal reserve capital too large	103
Too many federal reserve banks	69
Object to clearing provisions	65

This compilation contained in *What the Banks of the United States Think of the Federal Reserve System,* Circular published by the Guaranty Trust Company of New York, 1916.

eral Reserve Act resulting in abolition of exchange charges by members.

2. Ignorance or misunderstanding of the Federal Reserve Act.
3. Section 8 of the Clayton Anti-Trust Act which might have required resignation of certain directors.
4. Section 22 of the Federal Reserve Act, placing certain limitations on relations between a bank and its officers, directors, employees, and attorneys.
5. Section 11 (k) of Federal Reserve Act granting fiduciary powers to national banks, thus antagonizing the trust companies.
6. Division of the country into unsatisfactory reserve districts.
7. Fear that membership would make stockholders of member state institutions doubly liable in case of insolvency, even where state law had no such requirements.
8. Certain limitations on acceptance powers laid down by Federal Reserve Act.
9. Open market operations of federal reserve banks causing them to compete with member banks.

The federal reserve agent at New York in his 1915 report to the Federal Reserve Board described the situation in such a complete and interesting manner that his words are reproduced here at some length:[81]

"It is among the country banks as a class that most of the apathy and hostility to the Federal Reserve System which still persists is found. Their opportunities and earnings are relatively small, and in order to live they must figure closely. They feel the loss of interest on reserve deposits; the absence, as yet, of dividends on their capital contribution; and the prospective loss or decrease of the exchange they generally charge on remitting for checks drawn upon them. Many banks in industrial centers are precluded by the activity of their business from taking advantage of the reduction in the required reserve. They believe that they will, in fact, be required to carry an even larger reserve than heretofore in order to obtain collection service for notes, drafts, and nonmember checks and the various other services now rendered by their reserve agents, but not yet undertaken by the reserve banks. It is very natural that they should view with reluctance the termination or dimunition of long standing

[81] 2 Fed. Res. Board, 1915, pp. 179–181.

business association with their reserve agents. Few of them, as yet, conceive the reserve bank as their active reserve agent, performing all the services which go with the relationship. The dormant accounts most of the banks maintain with the reserve bank, are, perhaps, indicative of their attitude toward it. Relatively few banks of this district are borrowers; in good times and bad they have been able when necessary to borrow from their city correspondents on bonds or on the indorsement of their directors, two avenues which are not to be closed to them. The rediscounting privilege has been little availed of and the larger functions of the Federal Reserve System such as influencing domestic rates and international gold movements through the development of a discount market and by dealing in foreign bills, appear remote from their spheres of activity. They feel that the system has few advantages to offer in return for the cost it entails upon them."

". . . . The attitude of the State institutions in New York City and other large cities to the reserve system is one of friendly support and of appreciation of its meaning and advantages to the banking and business interests of the country. They agree that ultimately, in order to give the system the strength and influence it should have, State institutions should join in, but they see no immediate need of doing so and are inclined to wait and observe what advantages it will develop for them. Some have expressed the belief that, without bearing the burdens of the system, they will, nevertheless, be able to participate indirectly in its advantages. The officers of some of the leading institutions have expressed a desire that before considering joining the system their status as members should be more fully defined by law and left less to the regulation of the Reserve Board. The attitude of state institutions in the country districts appears to be one of complete indifference."

CHAPTER VII

AMENDMENTS MADE TO ENCOURAGE MEMBERSHIP OF STATE BANKS

WHEN it was realized that the state banks and trust companies were not going to enter the federal reserve system in very large numbers, much effort was expended in an attempt to ascertain what were the reasons for their hesitancy and what could be done to change their attitude. As early as the 1914 meeting of the American Bankers' Association resolutions were adopted which declared that amendments to the Federal Reserve Act would be necessary before the state banking institutions would join.

A committee of twelve, including representatives of all the various groups of institutions belonging to the Association, was selected to confer with the authorities at Washington in order to secure amendments making membership more attractive to state institutions.[1] This committee went to Washington but accomplished little and reported to the spring meeting of the Executive Council of the Association in 1915 that the federal reserve system had been in existence such a short time that it was impossible to offer any constructive suggestions, and recommended that the subject be referred to the Federal Legislative Committee of the Association. This was done, but this committee also was unable to suggest any changes.[2] At the 1916 meeting of the Association another special committee was appointed from the Trust Company Section. Letters were sent to all members of this section asking for

[1] 40 Proceed., A. B. A., 1914, *Com. and Fin. Chron.*, Oct. 24, 1914, p. 140.

[2] *Com. and Fin. Chron.*, Sept. 18, 1915, p. 120.

suggestions, but the replies were unsatisfactory, and again it was found to be impossible to agree upon amendments.

The Federal Reserve Board endeavored to learn what changes the state institutions desired in the Federal Reserve Act, and to propose legislation which would satisfy these wishes in so far as they were consistent with the purposes for which the system was established. But for a long time the state institutions were not able to recommend anything of importance except that they should be given the right to withdraw.[3] Late in 1916 the Federal Advisory Council was requested by the Board to advise what steps should be taken to encourage the state institutions to join, but the Council replied that the terms were already reasonable and attractive enough, that the only thing to do was to carry on a campaign of education and let the system gradually reveal its usefulness.[4]

With the organization of the State Bank Section of the American Bankers' Association at the 1916 convention some progress began to be made toward formulating amendments. Meanwhile, the Federal Reserve Board drew up a list of tentative amendments which were published in the Third Annual Report, but the only change at that time recommended in section 9 was one permitting mutual savings banks to become associate members.[5]

During 1916, specific suggestions began to be more in evidence. Wide discussion of the relationship of the state institutions to the federal reserve system was beginning to bear fruit. One important investigation was that made by the Guaranty Trust Company of New York. The Executive Committee of the State Bank Section of the American Bankers' Association sent out a list of questions to the state institutions. Approximately 750 banks replied, most of whom stated that they would join if the law

[3] Willis, H. Parker, *The Federal Reserve*, pp. 266–267.

[4] 2 Fed. Res. Board, 1918, p. 814.

[5] 3 Fed. Res. Board, 1916, p. 139. Mutual savings banks have not yet been given this privilege.

was changed as they desired. In answer to the questions, they listed the changes they thought necessary. The various obstacles mentioned by them have all been discussed in the previous chapter.

The Executive Committee of the State Bank Section met at Briarcliff Manor, New York, in May, 1917, where the results of the state bank questionnaire were considered. By invitation, Governor Harding and Mr. Delano of the Federal Reserve Board, attended this meeting and discussed with the committee proposed amendments to the Federal Reserve Act. As a result of this conference the amendments which it considered necessary were drafted. The Executive Committee then unanimously adopted resolutions stating that it believed that the proposed amendments would eliminate most of the chief objections to membership.[6]

Congress was apparently willing to make any reasonable changes, but had been unable to secure authoritative information as to what was desired. While the Briarcliff meeting was taking place, Congress was in special session, having been called by the President to receive his message asking for the declaration of war and to enact the necessary measures to render effective our participation in the conflict. The amendments were submitted to Congress and were enacted into law June 21, 1917, after little debate.

Before discussing these amendments, a brief survey of the amendments to the Federal Reserve Act up to this time as they affected the state institutions will be given. Up to 1917, the law establishing the federal reserve system had been amended by the Acts of August 4, 1914, August 15, 1914, March 3, 1915, and September 7, 1916. All of these changes contained provisions affecting the state bank and trust company members. That of August 4, 1914, extended the privileges of the Aldrich-Vreeland Act to state bank and trust company members of the federal reserve

[6] *Journal A. B. A.*, June, 1917, pp. 973–974.

system. The Act of August 15, 1914, amended section 19 so that a member state institution could, where the state law permitted it, continue to keep a portion of its legal reserves against deposits on deposit with other state banks for three years.[7] The 1915 amendment changed paragraphs 3, 4, and 5 of section 13 to authorize the Federal Reserve Board, at its discretion, to increase up to 100 per cent of its capital and surplus the amount of drafts, notes, and bills of exchange, based upon the exportation or importation of goods, which a member bank might accept and a federal reserve bank might rediscount.[8]

The Act of September 7, 1916, was the first amendment of any length.[9] While none of its provisions were aimed directly at the state institutions, it will nevertheless be summarized here because it tended in general to make membership more attractive. It revised the terms of section 13 of the Act so as to authorize the federal reserve banks to receive on deposit from member banks all checks and drafts which were payable on presentation. This was to aid in the extension of the clearing and collection system, and played an important part in the controversy which aroused so much bitterness later. Member banks were given permission, when authorized by the Federal Reserve Board, to carry in the Federal Reserve Banks any portion of the reserves up to that time required to be held in their own vaults. Member banks were relieved from the necessity of executing waivers of demand, notice, and protest for notes, drafts, and bills of exchange presented for rediscount, the indorsement now serving that purpose. The rediscounting of agricultural or live stock paper was limited to a percentage of the total assets of the federal reserve bank to be determined by the Federal Reserve

[7] For the two 1914 amendments, see I Fed. Res. Board, 1914, pp. 44–46.

[8] This clause was inadvertently omitted in the amendments of Sept. 7, 1916, and had to be replaced by those of June 21, 1917.

[9] For entire draft of this amendment see 3 Fed. Res. Board, 1916, pp. 134–139.

Board, instead of a percentage of the capital as formerly. Previously, the federal reserve banks had not been allowed to rediscount for a member bank paper bearing the signature or indorsement of any one person, company, firm, or corporation to an amount greater than 10 per cent of the capital and surplus of the member bank, whether this person, firm, or corporation was the *borrower* or not. This amendment provided that this limitation applied only to the notes, drafts, and bills bearing the signature of any one *borrower*. Permission was also given to member banks, under certain conditions, to accept drafts or bills of exchange growing out of transactions involving the domestic shipment of goods, where formerly only acceptance of those arising out of the importation or exportation of goods had been permissible.

One amendment, while not a change in the Federal Reserve Act, but in the Postal Savings Act, affected certain member and nonmember state institutions. In 1914 there had been some agitation to allow nonmembers to receive postal savings deposits. A bill was finally passed under the provisions of which these deposits were not required to be held in member banks only. President Wilson vetoed it for the reason that government money should be in banks subject to government control. The bill was then redrafted so that nonmembers were to be given one year to join the system or lose the deposits, but it was never reported from committee. The committee on Postal Savings Banks of the Saving Bank Section of the American Bankers' Association made an unsuccessful protest against the President's veto.[10] Other attempts were made to gain permission to have these deposits placed in nonmember institutions, but they were unsuccessful.[11] Finally, on May 18, 1916, the Postal Savings Act was amended to permit deposits in a nonmember bank in a community where there

[10] *Com. and Fin. Chron. Supp.*, Oct. 24, 1914, p. 175.
[11] *Com. and Fin. Chron. Supp.*, Sept. 18, 1915, p. 181.

was no member bank, or in which the member banks would not or could not qualify.[12]

It can readily be seen that while these amendments liberalized certain sections of the Federal Reserve Act, making membership somewhat more attractive to state institutions, yet they did little toward removing the more fundamental criticisms made by the state institutions. It was this which the 1917 amendments endeavored to accomplish. The accusation that the federal reserve system was devised only for national banks should have been forever dispelled by the attention given to the question of making the system more satisfactory to state institutions in the framing of the Act of June 21, 1917.

The 1917 Amendments

What objections to membership in the federal reserve system were removed by the 1917 amendments? In the first place, section 9 of the Federal Reserve Act was revised so as to permit withdrawals from the system upon six months' written notice to the Federal Reserve Board, and the surrender and cancellation of the stock held by the state institution in the federal reserve bank. But no reserve bank could, except with the permission of the Federal Reserve Board, cancel in any calendar year more than 25 per cent of its capital stock for such a purpose. Upon the surrender of stock and the settlement of all indebtedness to the reserve bank, the withdrawing institution was to receive the amount of its paid-in subscription with interest at the rate of one half of 1 per cent a month from the date of the last dividend payment. This enacted into law that part of the Board's 1915 regulations permitting withdrawal. It cut, however, the period of notice from twelve months to six, and increased the amount which might be cancelled in any one year from 10 to 25 per cent of the

[12] For a history of the operations of the Postal Savings System, see Kemmerer, E. W., *Postal Savings*, Princeton University Press, 1917.

capital stock of the reserve bank. This removed one important objection.

Another change allowed the state banks and trust companies to retain their full charter and statutory rights under state law upon entering the system. This meant that they could continue to exercise all the corporate powers granted to them by the state in which they were created. These rights were, however, made subject to the provisions of the Federal Reserve Act and the regulations of the Board made pursuant thereto. While there was fear that this reservation might work hardship, yet the main disadvantage in this respect was now permanently removed. This again wrote into the law part of the 1915 regulations.[13]

That part of section 9 which imposed upon the member state institutions the same restrictions that applied to national banks regarding the amount which might be lent to any one person, firm, or corporation was removed. In its place appeared a clause, which permitted such loans in excess of 10 per cent of the lending bank's capital and surplus. But it prohibited the federal reserve banks from rediscounting for any state bank or trust company any paper of any one borrower who was liable to the state bank for an amount greater than 10 per cent of the capital and surplus of the lending bank. The discount of bills of exchange drawn against actually existing values, or of paper actually owned by the person negotiating it was not to be considered as borrowed money in the sense of this limitation. It was further required that a certificate to the effect that the borrower had not exceeded this limit must accompany all paper presented for rediscount at the reserve bank. Another objection was thus removed. But the fact that if a borrower was indebted to a member state institution for an amount greater than 10 per cent of the member banks'

[13] Mr. J. H. Puehlicher, President of the State Bank Section of the American Bankers' Association, gave the credit for the amendment permitting the retention of state charter and statutory rights to Governor Harding of the Board. *Journal A. B. A.*, Oct., 1918, p. 246.

capital and surplus no paper whatsoever of that borrower could be rediscounted caused further objections. This, it was claimed, would still be a serious restraint on the lending power of the state institutions.

Section 21 of the original Act gave the Comptroller of the Currency power to examine and require reports from all state member banks, as well as national. A clause of the 1917 amendments took away from the Comptroller this right. Thereafter, the state institutions were to be subject to federal examination only at the direction of the Federal Reserve Board or of the federal reserve bank by examiners selected or approved by the Federal Reserve Board. At least three reports of condition and of payment of dividends must be submitted each year to the federal reserve bank. The Board might also order a special examination at the expense of the bank examined.

The reserve requirements were greatly lowered. All member banks were thereafter to maintain 3 per cent instead of 5 per cent reserve against time deposits (i. e., deposits payable after 30 days notice, including savings accounts, certificates of deposit, and postal savings deposits). Against demand deposits banks not in reserve or central reserve cities were to keep 7 per cent instead of 12 per cent. Banks in reserve cities were to keep 10 per cent reserve instead of 15 per cent, and those in central reserve cities were to keep 13 per cent against demand deposits instead of 18 per cent as formerly. These reserves were in the future to consist of a balance with the federal reserve bank. Deposits in other banks and cash in vaults could not thereafter be counted. But no limitation was placed on the way in which this balance was to be created, so it might all be obtained by rediscounting. These are the present reserve requirements.[14]

[14] Another amendment to section 19 made on Sept. 26, 1918, permitted member institutions in outlying districts of central reserve and reserve cities, on affirmative vote of five members of the Board to carry the same reserves as banks in reserve cities or country districts, respectively. 5 Fed. Res. Board, 1918, p. 263.

The clause providing that no member bank could keep on deposit with any nonmember institution a sum in excess of 10 per cent of its capital and surplus was changed so as to apply only to deposits with nonmember state banks and trust companies. So in the future deposits above this amount in private banks and savings banks were permissible.

The prohibition against member banks acting as agents for nonmembers in rediscounting at the federal reserve bank was reënacted.

Section 22 was amended so that directors, officers, employees, or attorneys of member institutions might receive the same rate of interest as that paid to other depositors on deposits in the bank with which they were connected. The amendment also stated that notes, drafts, bills of exchange, or other evidences of debt executed or indorsed by directors or attorneys of a member bank might be discounted with this bank on the same terms and conditions as other paper upon the affirmative vote or written assent of at least a majority of the directors. The most disadvantageous part of this section was therefore remedied, although another amendment was later necessary in order to remove all objections to this limitation.

It must be concluded that the chief objections to membership that had substantial basis were removed by these admendments for all banks and trust companies located in states where the laws were favorable. A member state institution might now withdraw if it so desired; it could retain its state charter and statutory rights upon entering; restrictions on loans were liberalized; state institutions were no longer subject to the jurisdiction of the Comptroller of the Currency; reserve requirements were reduced; acceptance powers were broadened; and section 22 was rendered less drastic in its prohibitions. These amendments were also responsible for removing the state institutions from the restrictions of the Clayton Anti-Trust Act, for the

Acting Attorney-General of the United States on September 10, 1917, stated that the clause permitting state institutions to enter with their full charter and statutory rights secured for the state institutions full control over the choice of their directors. Therefore the Clayton Act could not interfere.[15]

Some further sections of these admendments possess importance for later parts of this study. Section 3 was revised to authorize the Federal Reserve Board to permit or require any federal reserve bank to establish branches within its district. Section 13 was amended to permit federal reserve banks to receive from *nonmember* banks and trust companies, solely for the purposes of exchange or collection, deposits of currency, national bank notes, federal reserve notes, checks and drafts payable upon presentation, and maturing notes and bills of exchange. These nonmember banks and trust companies must, however, maintain with the federal reserve bank of their district a balance sufficient to offset the items in transit held for their account by the federal reserve bank. This amendment threw open the clearing and collection system to all nonmembers maintaining the required deposit. Another clause in this section authorized a member or nonmember bank or trust company to make "reasonable charges to be determined and regulated by the Federal Reserve Board, but in no case to exceed 10 cents per $100 or fraction thereof, based on the total of checks and drafts presented at any one time, for collection or payment of checks and drafts and remission therefor by exchange or otherwise; but no such charges shall be made against the federal reserve banks." This last clause, prohibiting any federal reserve bank from paying exchange charges, played an important part in the controversy over par collection of checks.

Section 13 was further amended to restore the provision, put in the Act on March 3, 1915, but inadvertently omitted

[15] *Fed. Res. Bull.*, Oct. 1, 1917, pp. 744–746.

by the amendments of September 7, 1916, that member banks or trust companies, upon authorization by the Federal Reserve Board, might accept drafts and bills of exchange arising out of transactions involving the importation or exportation of goods up to 100 per cent of the capital and surplus of the accepting bank or trust company.

Another amendment passed at the same time permitted the issue of federal reserve notes against gold, or against 15 day notes of member banks and trust companies which were secured by commercial paper or government securities.

The chief clauses of the amendments affecting the membership of the state institutions have now been summarized and it is easy to see that, in supporting these changes, the Federal Reserve Board was endeavoring to make membership more attractive for the state institutions in every way that would not result in a lowering of the standards of the system or a deviation from the attainment of its main purposes. It was the opinion of the Board that the principal obstacles to membership had now been removed,[16] and in this view it was supported by many state bankers.

A number of state banks and trust companies entered the system early in 1917 upon the assurance that these changes would be made in the law. Among them was the Mississippi Valley Trust Company of St. Louis, which published and circulated widely a pamphlet called "Reasons Why One State Institution Entered the Federal Reserve System." This institution asserted that the 1917 amendments had removed the main objections to membership. Mr. J. H. Puelicher, President of the State Bank Section of the American Bankers' Association, in commenting upon these amendments said: [17]

"The Federal Reserve Act as amended is the greatest piece of financial legislation that has been written into the laws of

[16] 4 Fed. Res. Board, 1917, p. 14.
[17] *43 Proceed. A. B. A.*, 1917, p. 132.

this country since the adoption of the constitution. It enables the unifying of the banking system of the United States."

The following months were to witness the beginning of a rapid movement of state institutions into the system. The conditions accompanying this rapid increase in membership and the reasons for it will next be discussed.

CHAPTER VIII

MEMBERSHIP OF STATE BANKS DURING THE WAR

THE amendments of June 21, 1917, were passed by Congress with so little delay because it was believed that every effort must be made to bring in as many state banks and trust companies as possible at once in order to strengthen the banking power and financial fabric of the country during the critical period of war activities through which the nation was passing.

It is doubtful whether in spite of the war there would have been a large influx of state institutions had it not been for the appeals which were finally made to their patriotism. The number of member state institutions increased very slowly, from fifty-six on July 1, 1917, to eighty-nine on October 1. The country had been at war for six months by this time. The small number of state bank and trust company members was believed to be a weak spot in the financial structure. It was thought that if they could be induced to join in larger numbers it would make the task of financing the war and war industries an easier one because it would lead to a greater centralization of control and a more complete mobilization of banking resources. While so many institutions remained outside there was danger that there would be difficulty in carrying out any concerted policy because of so many independent and uncontrolled banking institutions. Therefore, herculean efforts were put forward to bring them in by appealing to the patriotism of the banking officials.

At the annual convention of the American Bankers' Association in September, 1917, addresses were made urging the state banks and trust companies to join for patriotic

reasons. Many of those present believed that it was the patriotic duty of every eligible institution to apply at once. Others held the opposite view. The convention agreed unanimously on the appointment of a federal reserve membership committee, with power to appoint sub-committees in every reserve district, charged with the task of urging upon eligible institutions the necessity of making application to join.[1] To the members of this committee and its sub-committees belongs much of the credit for the increase in the number of member state institutions which followed.

Among the speakers at the convention was Secretary of the Treasury McAdoo. He asked the nonmembers to enter the federal reserve system as a patriotic duty. Governor W. P. G. Harding, of the Federal Reserve Board, was present and made a similar appeal. After relating how the Board had labored to satisfy the state institutions he appealed to the nonmembers in these words: [2]

"Are the Federal reserve banks worth while? Would you care to have them abolished? If they are worth sustaining, should they be supported almost entirely by one class of banks or should all unite in upbuilding them? Will their strength be augmented and the financial welfare of the country further safeguarded by your membership? Ask those banks which are already members whether their charter powers have been ham-

[1] This committee consisted of the following bank and trust company officers:

J. H. Puelicher, Marshall and Ilsley Bank of Milwaukee, Chairman; Philip Stockton, Old Colony Trust Company of Boston; F. H. Sisson, Guaranty Trust Company of New York; J. H. Mason, Commercial Trust Company of Philadelphia; A. P. Coles, Central Bank and Trust Corporation of Atlanta; H. C. McEldowney, Union Trust Company of Pittsburg; William Ingle, Baltimore Trust Company of Baltimore; George E. Trimble, Fidelity Trust Company of Kansas City; Breckenridge Jones, Mississippi Valley Trust Company of St. Louis; S. B. Montgomery, State Savings Loan and Trust Company of Quincy, Illinois; F. W. Elsworth, Hibernia Trust and Savings Bank of New Orleans; Nathan Adams, American Exchange National Bank of Dallas, and R. R. Rutter, Spokane and Eastern Trust Company of Spokane.

[2] *Journal A. B. A.*, Oct., 1917, p. 258.

pered or curtailed by their membership; whether regulations of the Federal Reserve Board have interfered with their business or methods of doing business; whether Federal reserve banks have been arbitrary in their dealings; ask them if they have had difficulties in getting from the Federal reserve banks any accommodations to which they were entitled, or, if they have had no occasion to ask for accommodations, what the knowledge is worth that the accommodation can be had when wanted.

"Every dollar of reserve carried with the Federal reserve banks adds to their power to maintain sound and healthy banking conditions, to respond to any demands which may be made upon them, and to help our country win its fight for liberty and a safe and lasting peace. Then add up the figures—strike a balance, and your applications for membership will follow."

President Peter W. Goebel, of the Association, reminded the state institutions that as long as they were nonmembers they were receiving the benefits of a stability to which they did not contribute and that membership at this critical time was evidence of patriotism. John H. Puelicher, President of the State Bank Section, took the same position in the course of a powerful address in which he said, "I cannot see anything that a state banker, from the most selfish point of view, could do that would be more beneficial to his own institution and to the banking business as a whole, than to join the Federal Reserve System."[3] Benjamin Strong, Jr., Governor of the Federal Reserve Bank of New York, was also present and added his admonition, concluding: "It may indeed rest with you state bank men to determine what shall happen to our boys—and they *must* come home victorious." The presence of such a distinguished array of speakers at this meeting shows how important state bank membership was believed to be at this time.

What was the response of the state bankers? The evidence shows that the majority of them saw no reason why they should become members. They asserted that

[3] *Journal A. B. A.*, Oct. 1917, p. 272.

they could be of as much assistance outside of the system as in it. Certain remarks of Mr. Fred Collins and Mr. Sterling Fort of Tennessee and of Mr. George W. Rogers of Arkansas show the attitude of many state bankers. Mr. Collins said in part: [4]

"I do not believe in the banks of the country joining the Federal reserve system. If I could have my way, I would like a committee to be appointed here to find some way that I can show my patriotism without joining the Federal reserve system. If they want to shut me up in one of those submarines and throw me in the ocean, it is all right, because my troubles would begin and be over with sometime, and I would know it; but with John Skelton Williams punching at somebody all the time, nobody knows what kind of an instrument he is going to punch with the next time, and I cannot see my way to it."

Later on in the debate, Mr. Collins felt called upon to utter these additional sentiments: [5]

"I do not think it is any more necessary for me to join the Federal reserve system to show my patriotism than it is for me to go down here to one of these hotels and let them charge me three and a half dollars for a plate of soup."

Mr. George Rogers stated: [6]

"First, I want to say that it would be a calamity to the A. B. A. and to these United States of America, possibly, if all the state banks joined this system, because it would eliminate the state banking system and the State Bank Section of the American Bankers' Association, and you, gentlemen, would be deprived of the pleasure and profit of associating with each other. You would have to go over to the National Bank Section."

Mr. Sterling Fort argued: [7]

"Now, I don't want to be placed in an attitude of fighting the Federal Reserve System, because I think it is one of the greatest things that was ever instituted for the banking system of the United States, and I am for it—except that I don't belong to it.

"Now, I am just as honest as I can be when I say that I

[4] 43 Proceed. A. B. A., 1917, p. 683.
[5] *Ibid.*, p. 709.
[6] *Ibid.*, p. 678.
[7] *Ibid.*, p. 687.

believe it is to the interest of this country that this system should remain as it is, some Federal reserve system, some state banks, and this is the reason: The National banks keep John Skelton Williams scared with the state banks. If you put all the state banks out of business, who is going to scare John Skelton Williams?"

Comment on the foregoing statements by these three state bankers would be superfluous. They are quoted at some length because they are typical of many that were made at this time.[8] It seems absurd that bankers should

[8] The impression that the appeals to patriotism made on one state banker of South Dakota is shown by the following letter written after his return home from the convention: "I attended both meetings of the State Bankers' Section and was fed up on Federal reserve talk to the exclusion of everything else.

"When Mr. Puelicher delivered his very scholarly address as head of the state section, I fondly hoped for some reference at least to the problems of the small state banker. But that also, was a very able discourse on the Federal reserve system. We had Federal reserve served out to us in every course, beginning with the fruits and soups and ending with the demitasse.

". . . The fact is that thousands upon thousands of the small country state banks are not and probably never will be members of the Federal reserve system, as it would not be to their advantage to become such. . . .

"Another thing that is not doing the Federal reserve system any good is the attitude being taken by some of its leading officials in advancing the idea in advertising, in interviews, in newspapers and in correspondence with state bankers implying or insinuating, if not directly stating, that state bankers who do not unite with the Federal reserve system show a lack of patriotism.

"The ordinary state banker is wondering if his treatment being such as it is outside of the Federal reserve system, what it would be after he got in.

"One more criticism that the writer has heard advanced by a great many small country bankers was on account of the attitude taken by the managers of the Federal reserve banks in my district following the first Liberty Loan sale campaign. At the close of the campaign the Federal reserve organization took the entire credit for the results according to their interviews in the public press, entirely ignoring the state banker and his active part in the great drive. It seems to me that this shows a serious lack of courtesy and diplomacy. In my own county, for instance, we have sixteen banking corporations, fourteen of which are of the state bank variety and two are members of the Federal reserve. My observations are that there was no difference shown in patriotism or efforts to further the sale in any of the banks. Certainly, the Federal reserve fellows had no edge on the other fellows." *Journal A. B. A.*, November, 1917, pp. 393-394.

still be talking about what they feared the Comptroller of the Currency would do to them when this government official had been shorn of his control over the state institutions by the amendments approved the previous June.

Mr. Frank W. Blair, President of the Union Trust Company of Detroit, came to the defense of the nonmember trust companies at this meeting. He denied the charge that they were unpatriotic. He said they would join if the benefit to the government justified the sacrifice of private interests which would be necessary. Membership in the system was no proof of patriotism, he continued, for many trust companies did not carry on a commercial business and so would be of no help to the system. The only way in which the system would benefit would be that it would have the gold of the member banks, but in response to an appeal from the Federal Reserve Board most of this had been turned in already by the nonmembers, or would be very soon. Furthermore, he continued, the trust companies had little paper eligible for rediscount. It was also feared that the government would attempt to interfere with the trust business, causing conflicts with state laws. There was, he said, still considerable fear that membership would result in dual supervision and government autocracy, for even if the banks and trust companies joined, they did so under the regulations of the Federal Reserve Board. Finally, concluded Mr. Blair, the Clayton Anti-Trust Act would compel them to lose many of their prominent directors upon uniting with the system.[9] Mr. J. F. Curtis, of the Federal Reserve Bank of New York, replied to Mr. Blair. Mr. Curtis admitted that the gold had been turned into the system in exchange for federal reserve notes, but the trust companies were still outside and not tied up to the main reservoir of credit. This constituted a weak spot. Fear of autocratic control by the Federal Reserve Board was exaggerated. The Board had no intention of attempt-

[9] *Ibid.*, pp. 343–345.

ing to interfere with the control by the various states over fiduciary powers. Finally, said Mr. Curtis, Mr. Blair was ignorant of the fact that the Acting Attorney-General of the United States had rendered an opinion to the effect that the Clayton Act did not apply to state institutions.[10]

It was clear that a great majority of the state bankers did not believe that it was their patriotic duty to become members of the system. More appeals were, however, in prospect. In the Journal of the American Bankers' Association for October, 1917, President Charles A. Hinsch, of the Association, published a ringing appeal telling the state bankers in strong terms where their duty lay:

> "The business of the country is now war. To the business of war everything else is incidental. The farmer, the merchant, the manufacturer and the banker have duties as well as the soldier and the sailor. . . . In this great crisis we must place at the disposal of the government, in the common cause, our goods, our energies, our brains, our money, our time, ourselves, if we are to achieve the great purpose of a victorious peace.
>
> "To the country at this time the banks holding state charters owe the special duty of joining the Federal reserve system. They may retain all the privileges they now enjoy and they may withdraw when they please, but, regardless of conditions, patriotism dictates that during the period of the war the banking system must be unified, that every ounce of banking strength be mobilized and concentrated in the reserve system for the common welfare and the insurance of victory."

But so slow were the state institutions to respond that the President of the United States, on October 13, uttered a stirring appeal to them, saying: [11]

> "It is manifestly imperative that there should be a complete mobilization of the banking reserves of the United States. All who are familiar with financial operations must appreciate the importance of developing to the maximum our banking

[10] *Ibid.*, p. 349.

[11] *Fed. Res. Bull.*, Nov. 1, 1917, pp. 827–828. Governor Harding says in his book "The Formative Period of the Federal Reserve System" that this appeal was drafted by the Board for the President's signature, pp. 82–83.

power and of providing financial machinery adequate for meeting the very great financial requirements imposed upon the country by reason of the war. A vigorous prosecution and satisfactory termination of the war will depend in no small degree upon the ability of the Government not only to finance itself, but also to aid the Governments associated with it in the war, which must be kept supplied with munitions, fuel, food, and supplies of all kinds. The banking problem involved is one which concerns all banks alike. Its solution does not depend upon the National Banks alone, nor upon the state banks. The burden and privilege must be shared by every banking institution in the country. The important functions of the Federal Reserve Banks in the sale of the Government's securities, in receiving and transferring the billions of dollars involved, in supplying credit facilities, and in protecting the reserves of the country, have become so familiar to all that I am sure it is unnecessary to dwell upon or expound them.

"The extent to which our country can withstand the financial strains for which we must be prepared will depend very largely upon the strength and staying power of the Federal Reserve Banks.

"May I not, therefore, urge upon the officers and directors of all non-member State banks and trust companies which have the required amount of capital and surplus to make them eligible for membership, to unite with the Federal Reserve System now and thereby contribute their share to the consolidated gold reserves of the country. I feel sure that as member banks they will aid to a greater degree than is possible otherwise in promoting the national welfare, and that at the same time, by securing for themselves the advantages offered by the Federal Reserve System, they will best serve their own interest and the interest of their customers. I believe that cooperation on the part of the banks is a patriotic duty at this time, and that membership in the Federal Reserve System is a distinct and significant evidence of patriotism.

". . . Permit me to urge that every bank officer and bank director owes a solemn obligation to the country which I am sure they wish to discharge. I, therefore, wish again to impress upon them my solemn conviction that they can best measure up to their duties and responsibilities through membership in the Federal Reserve System."

The state institutions now began to enter the system

in greater numbers. Twenty-eight joined in October, fifty-nine in November and seventy-four in December. On the first of January, 1918, there were 250 member state institutions with capital and surplus of $520,000,000 and resources of $5,000,000,000. These figures reveal the fact that the institutions entering were among the largest state banks and trust companies in the country. In January, ninety-three more were united, and the movement continued unabated so that by December 31, 1918, there were 930 listed as members with capital and surplus of approximately $760,000,000 and resources of $7,500,000,000.

A number of the larger institutions which joined during 1917 published statements as to their reasons for so doing, to encourage other banks and trust companies to do likewise. The Guaranty Trust Company of New York announced: [12]

> "As the Federal Reserve Act stands to-day, practically every serious objection to membership, which was evident at the time the law was passed has been removed, and therefore it was with genuine satisfaction that the Guaranty Trust Company decided to apply for membership in the system. . . . We believe that membership in the Federal Reserve System, especially at this time, is a distinct and significant evidence of practical patriotism."

The Bankers' Trust Company and Equitable Trust Company of New York were among those joining at this time. They also stated that they did so because they believed it to be their duty to aid in the financing of the war. The entrance of these trust companies, the largest in the country, did much to encourage others to unite with the system. Patriotic reasons were also given by the Central Trust Company, Metropolitan Trust Company, New York Trust Company, the Pacific Bank, W. R. Grace and Company's Bank, all of New York; by the Girard Trust Company of Philadelphia, and by the Hibernia Bank and Trust

[12] *Fed. Res. Bull.*, Nov. 1, 1917, p. 845.

Company of New Orleans for their decision to become members.[13]

Most of the State Banking Commissioners and Superintendents cooperated heartily and advised the state institutions to join. For example, S. G. Sargent, Superintendent of Banks in Oregon, on November 10, 1917, wrote to the institutions under his jurisdiction that until the amendments of June 1917, had been enacted he had not been able to advise them to apply for membership, but now they should do so, both from the viewpoint of patriotism and economic expediency.[14] The Federal Reserve Board recognized the value of the work being done by the various state banking supervisors and spoke appreciatively of them as follows: [15]

> "Since the date of the President's statement the banking departments of nearly all the States have expressed approval of membership in the Federal Reserve System on the part of the banks under their supervision, and the response of the banks has been most gratifying."

In its annual report for 1918 the Board again expressed its gratification over the attitude which had been taken by the state bank superintendents and the assistance they had given in encouraging the state institutions to join.

All during 1918 many prominent bankers continued to impress upon the state institutions that they owed an obligation to the country which required them to ally themselves with the federal reserve system. The federal reserve membership committee of the American Bankers' Association worked unceasingly also and was responsible for the entry of many banks and trust companies.

The situation with regard to the membership of the

[13] *Ibid*, pp. 836–837.
[14] *Ibid.*, Dec. 1, 1917, p. 934.
[15] 4 Fed. Res. Board, 1917, p. 10.

state institutions, with distribution by districts is shown by the following tables, for 1917 and 1918:[16]

Districts	Dec. 31, 1917.		Dec. 31, 1918.		
				Amounts in Thousands of Dollars	
	Number	Resources Amounts in Thousands of Dollars	Number	Capital and Surplus	Resources
Boston	14	$ 339,722	31	$ 57,656	$ 599,596
New York	44	2,707,541	101	277,492	3,488,611
Philadelphia	8	228,440	29	66,588	324,408
Cleveland	13	369,145	66	90,857	597,288
Richmond	14	43,804	37	16,002	110,430
Atlanta	20	150,656	54	26,424	249,532
Chicago	71	792,425	288	138,827	1,363,695
St. Louis	13	209,694	44	43,970	347,683
Minneapolis	16	27,527	70	8,259	81,861
Kansas City	9	68,099	27	8,489	96,796
Dallas	11	11,133	97	9,083	58,254
San Francisco	17	65,697	86	16,143	163,959
Total	250	$5,013,885	930	$ 759,790	$7,482,113

A study of these tables reveals the fact that the number of members in a district by itself is no measure of the banking power controlled by that district. The forty-four state member institutions in the New York district at the end of 1917, for example, possessed greater resources than the combined figures for all the other state institutions at that time members of the system. In 1918, the forty-four member state banks and trust companies in the St. Louis district had greater resources than 194 similar institutions in the Minneapolis, Kansas City, and Dallas districts. At the same time, 101 member state institutions in the New York district contributed nearly one-half of the total resources of the state institutions of the system.

What were the causes leading to the increase in membership during this period? Some of them may be ascer-

[16] Annual Reports of the Federal Reserve Board for 1917 and 1918.

tained from the reports of the federal reserve agents.[17] While the President's appeal was responsible for many new members, it was not the only reason.[18] In fact, it was reported from some districts that the President's proclamation had had little effect. Some state bankers said it was merely an incident of the war, or a subterfuge to get them into the administration's federal reserve system. The passage of the 1917 amendments was responsible for some entries. Removal of the state institutions from the operation of the Clayton Act brought in others. But extremely important was the fact that many state bankers began to experience a demand for increased loans and wished to be able to borrow from or rediscount with the federal reserve banks. Some of them wished to assure their own safety and get under cover for the period of the war. Up to the middle of 1918, however, the President's appeal was probably the most important single factor in the growth of state bank and trust company membership.

Another factor in producing a more favorable attitude among the state institutions at this time was the increase in the number of branches of the federal reserve banks which occurred during this period.[19] For a considerable

[17] 4 Fed. Res. Board, 1917, p. 363.
Ibid., p. 462.
Ibid., p. 437.
5 Fed. Res. Board, 1918, p. 487.
4 Fed. Res. Board, 1917, p. 224.

[18] Former governor Harding thinks that patriotism was a most important factor in increasing state bank membership, *The Formative Period of the Federal Reserve System*, pp. 84–85.

[19] Some bankers declared that the opening of branches was a deliberate bid for support of the system by the state institutions. One banker's publication commented up the innovation as follows:

"The state banks are to be wooed and won, and to be wooed whether they are won or not. The announcement of the opening of a branch in Spokane had coupled with it the prediction that the state banks in the vicinity would speedily begin to join. . . . The effect upon the state banks is yet to be demonstrated. Fifty-seven out of twenty-odd thousand have so far succumbed. They have been on the verge of flocking into the system for many months, but the verge holds firm and the flocking cannot be noticed. A sarcastic country banker has written a

(Continued on Next Page)

period after the establishment of the New Orleans branch, Atlanta was the only reserve bank possessing a branch. But during 1917 more were opened, Spokane and Omaha being the first in this year to commence operations. The federal reserve agent at Chicago claimed that the establishment of a branch at Detroit had stimulated interest on the part of nonmembers, and had resulted in some new applications.[20] This experience was duplicated in the Kansas City district when the Omaha branch was projected,[21] and in the San Francisco district when the Portland branch was opened.[22] With the opening of a branch at Salt Lake City all of the eligible banks in that city as well as some in the surrounding cities applied for membership.[23] The opening of the Buffalo branch in the New York district,[24] and the Cincinnati and Pittsburgh branches in the Cleveland district,[25] and the Oklahoma City branch in the Kansas City district brought similar results. The Federal Reserve Board commented upon the result of instituting branches as follows: [26]

> "In some cases the establishment of branches has been followed by accession to membership of a number of State banks in the localities served, and the usefulness of the branches has been greatly increased as a result."

letter to the editor about it. He suggests that the Reserve Board should hang up inducements like a circulation manager—a cuckoo clock for a new subscriber whose capital is $100,000 or under and a tea-set of fifty-six pieces of hand-painted porcelain for one of half a million; also a complete history of the people of Java, with pictures in four colors and twelve volumes for every subscriber with seven figures consumed in the relation of his capital and surplus. And the editor answered: "Well, why not?" Journal A. B. A., August, 1917, p. 85. One cannot avoid the comment that the editorial attitude of this magazine toward the federal reserve system at this time was not at all creditable or worthy of a publication of such standing in the banking world.

[20] 4 Fed. Res. Board, 1917, p. 437.

[21] *Ibid.*, p. 511.

[22] *Fed. Res. Bull.*, Dec. 1917, p. 943.

[23] 5 Fed. Res. Board, 1918, p. 733.

[24] 6 Fed. Res. Board, 1919, p. 326.

[25] And 7. *Ibid.*, pp. 358 and 459, respectively.

[26] Fed. Res. Board, 1918, p. 73.

Another reason frequently given at this time for the decision of many institutions to apply for membership was that during the Liberty Loan campaigns many of the banks came, for the first time, in close contact with the officers of the federal reserve system, and learned more about the operations of the federal reserve system, and became more favorable to it.[27]

Another factor in influencing the decision of certain banks was a further amendment to section 22 of the Federal Reserve Act. This had been previously amended in 1917, but there was still considerable uncertainty about its meaning. The Board was requested to interpret these amendments but the counsel of the Board decided that the matter of interpretation must be left to the courts as no ruling by the Federal Reserve Board could be pleaded as a defense by a person subsequently indicted by a federal grand jury for a violation of this section. Since the penalties which might be administered upon conviction were heavy, each bank was advised to act upon the advice of its own counsel. All the Federal Reserve Board could do was to advise the banks. of its understanding of the general purpose of the admendment.[28] Naturally, this was not satisfactory to institutions whose directors or officers might later have been prosecuted. So another amendment was advocated and became law on September 26, 1918. This prohibited any officer, director, employee, or attorney of a member institution from receiving a commission for procuring loans, or purchases, or discounts of any commercial paper or similar obligations. It also imposed the conditions under which a member bank or trust company might contract for or purchase or sell securities or other property where the other party interested was a director of the bank or trust company. Another provision was that no officer, director, employee, or attorney could be paid a higher rate

[27] *Ibid.*, pp. 546, 588, and 629.
[28] *Fed. Res. Bull.*, Sept. 1, 1917, pp. 694–696.

of interest on deposits than was paid to any other depositor. Those officers or directors knowingly violating or permitting violations of this section of the Act were made liable in their personal and individual capacity for all damages sustained by the bank or trust company, its shareholders, or any other persons. This amendment undoubtedly cleared up most of the ambiguity of this section.[29] Inasmuch as infraction of section 22 carried heavy penalties upon conviction, the bankers were justified in demanding that all uncertainty be removed. Commenting upon this amendment in its 1918 report, the Federal Reserve board said:[30]

> "The amendment to Section 22 of the Federal Reserve Act which relates to transactions between member banks and their officers or directors has cleared up the many ambiguities of that section and has removed what was regarded by many state banks as an obstacle to membership."

One policy adopted by the Federal Reserve Board in 1917 assisted the government to finance the war and at the same time resulted in an increase in the goodwill of the state institutions toward the federal reserve system. Permission was given to member banks and trust companies to act as agents for nonmembers in rediscounting the notes of the nonmembers at the federal reserve banks, when the proceeds of these notes were to be used by the nonmembers to buy or carry government obligations issued for the purpose of financing the war.[31]

It may be concluded, then, that the increase in the membership of state institutions to 930 by the end of 1918 was due not only to the appeals to their patriotism and the passage of the amendments of 1917, but also to a greater acquaintance with the operations of the system gained during the war financing, to a greater increase in the demand

[29] For a draft of this amendment see 5 Fed. Res. Board, 1918, p. 262.
[30] 5 Fed. Res. Board, 1918, p. 262.
[31] 4 Fed. Res. Board, 1917, p. 273.

for loans which made rediscounting a very valuable and profitable privilege, to the establishment of a number of branches, to the decision removing the state institutions from the restrictions of the Clayton Act, to assistance given to the state institutions in carrying government obligations, and to the amendment of section 22 of the Federal Reserve Act.

But although 930 banks and trust companies organized under state charters had entered the system by the end of 1918, and the number was increased to 1,181 by the end of the next year, it must be remembered that there were over nine thousand eligible state banks and trust companies which did not join during this period. An effort will now be made to determine the reason for their continued reluctance, in view of the fact that the 1917 amendments had removed many objections and that the President had made membership an evidence of a desire to give patriotic support to the government in war time.

Many of the nonmember banks and trust companies felt that it was unjust to accuse them of a lack of patriotism. They announced that membership was no evidence of a desire to give patriotic support to the government during war time, as there were many sound reasons why they felt themselves unable to make application to join. They resented the stigma which was placed upon them by President Wilson's appeal. Mr. Charles H. Sabin, President of the Guaranty Trust Company of New York, although his institution had become a member, warmly defended the nonmembers in these words: [32]

"Although we have evidence daily that the patriotism of state banks is just as ardent as that of national banks, lack of patriotism has at times been imputed to state banks that have not joined the Federal Reserve System. Some recent public utterances urging membership in the system have implied that there are about 20,000 state banks which, through prejudice or selfishness, refuse to ally themselves with it. As membership in the

[32] *Journal A. B. A.*, October, 1918, p. 225.

system depends on many considerations, it is obviously unfair to attribute it to lack of patriotism, without a full knowledge of all the facts in each case."

Many other bankers and trust company officials arose to defend the state institutions and proclaim their patriotism.[33]

Some of the reports of the federal reserve agents are illuminating on the question of the reluctance of the state institutions to join.[34] All the old objections to membership,

[33] See statements by Mr. Fred Collins, Mr. Sterling Fort, Mr. George W. Rogers, Mr. Frank W. Blair, and the letter from the South Dakota banker on pages 118-119 this volume for other comments by bankers on whether membership was a patriotic duty.

A commendable article from the Milwaukee Journal describing the attitude of the bankers is here reproduced in part:

"One well known banker of Wisconsin at the annual convention declared with considerable vehemence that the question of patriotism should be definitely left out when state banks consider the wisdom of joining the Federal reserve system. He added that the question for the rural banker is whether it is good for him to join the Federal system. A handful of bankers who heard this 'dollar talk' were shortsighted enough to approve of this gospel of extreme selfishness.

"Another banker of the state declared that it cost too much to belong to the Federal system, that too much is demanded of the banks that join. His plaint, too, was the conventional one that his constitutional rights to larger profits should not be interfered with by any agency designed to safeguard the entire banking system of the country.

"All of these men talk with the provincial candor of the neighborhood type of banker who sees nothing but the profit side of his year's accounts. Refreshing indeed was the larger call to duty of H. A. Moehlenpah, who declared with the fire of conviction that the national banks have held the bag long enough, that now is the time for state banks to come in and help make a real national system of banks, so that instead of merely 7,000 national banks, 27,000 American banks shall strengthen our financial organization.

"Bankers of Wisconsin were no doubt startled when W. A. Heath, chairman of the Federal Reserve Bank at Chicago, in answer to the charge of red tape, declared that rediscounting could be done as fast as the mails could carry acceptable paper and the credit could be established by telegraph if need be.

"Wisconsin bankers will live to see the day when the idea that rediscounting is only for panic times will be smiled at as a theory which the backwoods banker has even discarded. A few Wisconsin bankers need to take down the calendar, find the figure of 1917 there, remember the war, and make their conduct square with today's demands instead of with the ideas of the '70s and '80s." (Reprinted in the Journal A. B. A., August, 1917, p. 138).

[34] "The general attitude of State bank officers has apparently been

(Continued on Next Page)

except those removed by the 1917 amendments were still in evidence.

The laws in a number of states still militated against membership. Some of the states in the Boston district, for example Connecticut, Rhode Island, and Vermont, had not even late in 1917 given member state institutions the right to carry the same reserves as were required by the Federal Reserve Act.[35] Some of the states in this district required their banks to keep savings accounts segregated and invested in specified securities, with no specific cash reserve requirement.[36] Richmond, Dallas, Kansas City, and San Francisco reported in 1918 that changes in some of the state laws in those districts were still necessary to allow state members to carry the reserves stipulated by the Federal Reserve Act.[37]

The Federal Reserve Board realized that this difficulty existed, and gave it as a reason why so many institutions did not join.[38] The Counsel of the Board stated early in

more friendly than heretofore, evidenced chiefly by a frank admission, almost universally, that the Federal Reserve System has been the salvation of the country—agriculturally, commercially, and financially—and that the State banks indirectly have been the beneficiaries in this to the same extent practically that members of the system have shared in it. They say frankly that they would be unwilling to see former conditions restored. Financially, their attitude is that while they might be willing to come in as members, notwithstanding some loss of interest which they now get on balances, they are unwilling to forego the present returns from exchange charges. They are satisfied to enjoy the stability and prosperity and the profits arising from such conditions, due to the operation of the Federal Reserve System, but want to retain every source of profit which existed under the old system. They admit they want their items cleared at par. They are carrying at central points for this purpose considerable balances on which they receive a low rate of interest, whereas, these balances could be more profitably employed in regular loans, provided they could clear all items at par through the Federal Reserve Bank. Many express a willingness to become members 'if all the others would come in' thus establishing a universal par clearing plan, but each one hesitates about being the first and alone in 'going over the top.'" 4 Fed. Res. Board, 1917, pp. 403–404.

[35] *Fed. Res. Bull.*, Nov. 1, 1918, p. 1083.

[36] 4 Fed. Res. Board, 1917, pp. 224-225.

[37] 5 Fed. Res. Board, 1918, pp. 693-694, 659 and 733.

[38] 4 Fed. Res. Board, 1917, p. 10.

1919 that no legislation whatever enabling state institutions to join had yet been passed by Alabama, Arizona, Arkansas, Colorado, Delaware, Illinois, Indiana, Kansas, Maryland, North Carolina, Oklahoma, Tennessee, Utah, Vermont, West Virginia, and Wyoming.[39] While practically all of the states had almost at the outset of the establishment of the system given permission to their banks and trust companies to subscribe to the stock of the federal reserve banks, this was not enough. It was necessary to permit the state institutions which joined to carry the reserves which were prescribed for the federal reserve system. Otherwise many of the state banks and trust companies would be compelled to live up to the requirements of both systems at a considerable loss. Furthermore, it had to be made legal to reveal the information required for reports and examinations by the federal reserve banks. Practically the only state whose original law on this matter was satisfactory was Massachusetts. Pennsylvania remedied the situation very soon.[40] A number of state banking officials in spite of the absence of the necessary laws allowed the members to count their balances with the federal reserve bank as part of their legal reserve.[41] This relieved the situation greatly.

Some of the states passed laws during 1917 and 1918 permitting the substitution of the federal reserve requirements for those of the states by state member banks and trust companies. The need for uniform legislation on this subject was so great that at its 1918 convention the American Bankers' Association passed resolutions urging the various states to pass laws not only permitting state institutions to ally with the system and substitute the federal reserve requirements for those of the states, but also permitting the state authorities to disclose information regard-

[39] *Journal A. B. A.*, January, 1919, p. 37.

[40] For a copy of the original Pennsylvania Law see *Fed. Res. Bull.*, Sept. 1, 1917, pp. 666–667.

[41] 5 Fed. Res. Board, 1918, p. 659.

ing these institutions to the federal reserve authorities. Such banks, upon joining, should be vested with all powers conferred upon member banks by the Federal Reserve Act, such powers to be exercised subject to the restrictions and limitations imposed by the Act and the regulations of the Board. The state authorities should be permitted to examine the state members but the federal reserve authorities should be allowed to make examinations also.[42] The Counsel of the Federal Reserve Board drew up a summary of the situation as it existed at the end of 1918. This summary revealed the fact that there was great dissimilarity in the laws passed by the various states, and that most of the laws were very incomplete if the interests of the state institutions were to be satisfactorily protected. Such a situation seems to justify the reluctance of many state institutions to enter the system at this time.

To assist the state authorities in solving the troublesome question of framing a suitable law governing the membership of the state institutions the Counsel of the Federal Reserve Board drafted a law which he recommended for adoption.[43] It provides that state institutions should be permitted to subscribe to the stock of the federal reserve bank and should be required to carry only those reserves stipulated by the Federal Reserve Act. It also provided that any bank or trust company incorporated in a state should upon becoming a member be vested with all the powers conferred upon member banks by the Federal Reserve Act as fully and as completely as if such powers were specifically enumerated and described in the state law. All such powers would be exercised subject to all the restrictions and regulations imposed by the Federal Reserve Act, or by the regulations of the Federal Reserve Board, but the right was to be reserved to revoke or amend the powers so conferred. The proposed measure would make the state in-

[42] *Journal A. B. A.*, January, 1919, p. 410.

[43] Complete copy of this proposed law is to be found in the *Fed. Res. Bull.*, April 1, 1919, p. 367–368.

stitutions subject to the examinations required by the Federal Reserve Act, and the authorities of the state might in their discretion accept such examinations in lieu of the examinations required under the state law. The state authorities or their agents or employees were to be allowed to furnish to the Federal Reserve Board, the federal reserve banks, or to examiners appointed by the Board or the reserve banks, copies of all examinations made. They might also disclose to the Board or the reserve banks any information with reference to the condition of the affairs of the member state banks or trust companies. All other laws which might be inconsistent with any of the foregoing provisions were to be considered to be inoperative.

This draft of the proposed law received the approval of the Committee on State Legislation of the American Bankers' Association with the exception that the section dealing with examinations was considered to leave too little control in the hands of the state authorities. This committee recommended that this section should state that the member state banks and trust companies should continue to be subject to the supervision and examinations of the state authorities, but that the Federal Reserve Board should be given the right to make examinations if it so desired.[44] With this exception the draft of the Counsel of the Federal Reserve Board was approved and recommended for passage by the states interested. Many states have since passed this law in entirety, adopting the change suggested by the American Bankers' Association because greater power over examinations was left in the hands of the states than in the Federal Reserve Board draft.

It must be concluded, then, that in spite of the 1917 amendments many of the objections discussed in Chapter VI appear again and again during the war period, notwithstanding the patriotic urge to membership. Bankers are still heard protesting against the non-payment of interest

[44] *Journal A. B. A.*, January, 1919, p. 370.

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[44] *Journal A. B. A.*, January, 1919, p. 370.

on their reserve balances. The extension of the system for the par collection of checks, resulting in loss of exchange charges, was roundly attacked. The power of the Federal Reserve Board was still an object of criticism, and dual control by state and national authorities was still put forth as an obstacle to membership. It was evident that the benefits of the system were being freely passed on by the correspondents of the nonmembers. For this reason many stayed out. Many of the bankers were so indignant over being accused of a lack of patriotism that they would not have joined under any circumstances. The beginning of the vigorous attempts to widen the sphere of the par collection system to include nonmembers as well as members had the same effect.

What then shall be the general conclusion as to the action of the state institutions during the war period? It is true that by the end of 1918, as many as 930 state institutions were listed as members, and 1919 added 251 more. But there were over 9,000 eligible institutions who did not join. Should they have done so? Did the fact that they remained outside show that they were unpatriotic? A general condemnation cannot be visited upon the nonmember banks and trust companies, although many of the state institutions which did join were frank in accusing the nonmember banks of being deficient in patriotism. It must be remembered that the state institutions really played a very important part in the floating of the Liberty Loans during the war, a part which they claimed was never sufficiently recognized by the federal reserve authorities. When the requests went out from the reserve banks to the state institutions asking them to deposit their gold in the reserve banks and receive federal reserve notes for it, there was, where the state laws did not prohibit it, an immediate and gratifying response.[45] Where state laws prevented such ac-

[45] 4 Fed. Res. Board, 1917, pp. 273, 316, and 403; 5 Fed. Res. Board, 1918, pp. 546 and 659.

tion many of the state banks and trust companies assisted in the securing of suitable changes, in order that their gold reserves might be carried on deposit in the federal reserve banks.[46] When the state institutions were accused of a lack of patriotism, vigorous denials of this charge followed. They said the appeals were only subterfuges to increase membership in the system. It was pointed out that there were a number of good reasons for their aloofness. It was shown that many of the trust companies were not doing much of a commercial business and that their membership would bring no benefit either to themselves or to the federal reserve system. On the other hand, it was claimed that many of the trust companies were changing the type of their investments in order to include a certain amount of paper eligible for rediscount,[47] so that their membership was desirable. Many state laws made membership a burden, and where this was so, the banks and trust companies cannot be criticised severely. But it is certain, even granting the validity of these contentions, that the majority of eligible banks could have joined. Of those who did join, patriotism was probably the chief motivating factor, and the Federal Reserve Board gave them due credit for their decision.[48] The desire for security and opportunity to secure rediscounts may, however, have been more important. It is hard to say, but were there only a thousand institutions that could join during this period without great loss and disadvantage? The answer must be in the negative.

Those who joined for patriotic reasons are to be highly commended. Those who were not eligible, of whom there were ten thousand, had no choice. As the war period fades into the past it becomes increasingly difficult to accuse the eligible banks who remained out of a lack of patriotism. The financial operations of the war were carried on with a

[46] *Fed. Res. Bull.*, May 1, 1917, p. 335. *Trust Companies Magazine*, Oct., 1918, p. 411.

[47] 5 Fed. Res. Board, 1918, p. 409.

[48] 5 Fed. Res. Board, 1918, pp. 25–26.

great degree of success in spite of so many nonmembers. There was probably a semblance of the prevalent war hysteria in the frantic appeal made to them to enter. But the fact remains that the government had appealed to them, had assured them that their membership would be of great assistance, and they did not respond to the degree the government desired. They decided for themselves instead of acquiescing. Is this, we might ask, the patriotic course in time of war ? When it is remembered that they could have withdrawn at the end of the war should they have so desired, it must be concluded that their attitude was, to say the least, extremely disappointing.[49]

[49]Revised figures for membership changes among state banks and trust companies changes from 1915 to 1918 were issued by the Board in 1925. In a number of cases the figures will not agree with statistics previously given in this volume. Such discrepencies cannot be helped as the Board apparently never ceases revising previously announced statistics.

The Figures Are*

	1915	1916	1917	1918	Total
Membership, first of year	8	31	37	253	
Total additions	23	7	219	683	932
Admission of state banks	22	7	218	683	930
Conversion of national bank	1	...	1	...	2
Total losses	0	1	3	6	10
Merger between state member banks	...	...	...	1	1
Absorption of national bank	...	...	...	1	1
Conversion to national bank	...	...	1	1	2
Withdrawal	...	1	...	...	1
Other decreases	...	...	2	3	5
Net change	+23	+6	+216	+677	922
Membership, end of year	31	37	253	930	

* 12 Fed. Res. Board, 1925, p. 176.

CHAPTER IX

STATE BANK MEMBERSHIP, 1919-1922

MEMBERSHIP of state banks and trust companies in the federal reserve system continued to increase steadily up to the middle part of 1922 until 1,657 were enrolled.

In 1919 new enrollments were 284. Total state bank and trust company membership, however, at the end of the year showed a net increase over the previous year of but 251. The explanation for this difference lies in the fact that during the year the following changes in membership took place: Withdrawals, 9; consolidations, conversions and mergers, 17; voluntary liquidations, 4; absorption by nonmembers, 3. Membership of state banks and trust companies at the end of 1919 was 1,181 with resources of $9,-913,700,000. This was an increase of two and a half billions over the resources at the end of the previous year.

The addition to membership in 1919 was much smaller than that of 1918, due largely to the ending of the war with a consequent disappearance of the patriotic motive for joining, and a slackening in the demand for bank credit. The increase in business and speculative activity which took place in the latter half of 1919 and the first part of 1920 resulted in a larger enrollment during 1920 when 332 new member state institutions were added. Again, the new membership was offset somewhat by the loss of former members. In 1920 withdrawals were 12; consolidations, conversions and mergers, 19; absorption by nonmembers, 3; liquidations, 3. Other gains to membership came in 1919 and 1920 through the conversion of eleven national banks into state members. The increase in the number of applications for membership in 1920, after the decided slump in

1919, was partly due to an increasing demand for loans which made it desirable for many banks to be in a position to increase their lending power and their safety by borrowing or rediscounting at the federal reserve banks. Furthermore, the rediscount rates at the reserve banks were so much lower than the rates at which the members made loans that membership was highly profitable in many cases. The 1,481 member state banks and trust companies held resources of $9,826,794,000 at the end of 1920.[1]

During 1919 practically all of the reserve banks continued their campaign to induce the state institutions to join. They were given important assistance in this work by the Federal Reserve Membership Committee of the American Bankers' Association, the state banking supervisors, and the Federal Reserve Board. Some of the federal reserve banks, as a means of encouraging applications, published letters from member state institutions giving their estimate of the value of membership. The Federal Reserve Bank of Cleveland, early in 1919, published 20 letters from

[1] Statistics of membership for 1919 and 1920 are shown by the following tables:

DECEMBER 31, 1919
(Amounts in thousands of dollars)

Federal Reserve District	Number	Capital and Surplus	Resources
Boston	36	$ 64,385	$ 719,918
New York	122	320,123	4,283,636
Philadelphia	38	70,455	370,462
Cleveland	97	101,871	803,439
Richmond	46	19,285	166,007
Atlanta	64	35,553	389,854
Chicago	326	157,046	1,751,177
St. Louis	68	44,354	409,086
Minneapolis	86	10,455	107,139
Kansas City	47	8,353	119,953
Dallas	114	10,391	97,103
San Francisco	137	48,930	695,933
Total	1,181	$ 891,201	$9,913,707

(Continued on Next Page)

state institutions in Ohio, Pennsylvania, and Kentucky. All of these member banks and trust companies, with one exception, were well satisfied.[2] This exception was the Exchange Bank of Kentucky of Mount Sterling, Kentucky, which later withdrew.

The Federal Reserve Bank of Dallas in 1920 published a pamphlet containing letters from 27 state bank and trust company members in Texas, Louisiana, and New Mexico, including a number of institutions with only $25,000 capital. These banks and trust companies found little cause for dissatisfaction.[3]

The Federal Reserve Bank of Chicago in 1920 distributed in pamphlet form letters from 12 banks in Michigan, Wisconsin, Iowa, and Illinois. The same general satisfaction with membership in the system was evident there.[4]

The Federal Reserve Bank of San Francisco, at the

DECEMBER 31, 1920
(Amounts in thousands of dollars)

Federal Reserve District	Number	Capital and Surplus	Resources
Boston	39	$ 73,537	$ 724,063
New York	134	362,810	3,929,629
Philadelphia	46	73,051	382,301
Cleveland	111	111,480	879,621
Richmond	56	24,281	158,937
Atlanta	84	41,389	352,480
Chicago	358	179,732	1,774,753
St. Louis	91	49,246	386,546
Minneapolis	116	13,359	122,785
Kansas City	63	12,003	136,221
Dallas	185	21,110	137,530
San Francisco	198	73,025	841,928
Total	1,481	$1,035,023	$9,826,794

[2] *Federal Reserve Bank of Cleveland, The Answer.* Published by the Bank.

[3] *Federal Reserve Bank of Dallas. Why State banks should join the Federal Reserve System.* Published by the bank in 1920.

[4] Federal Reserve Bank of Chicago. Membership in the Federal Reserve System from the State Bank Viewpoint.

same time, printed copies of letters from 90 member state institutions in Arizona, Oregon, California, Idaho, Utah, and Washington. There was not so much satisfaction among the members in this district; in fact there was considerable complaint about non-payment of interest on deposits, par collection of checks, red tape, the number of reports, and the system of examinations. In general however, the testimony was somewhat favorable to membership.[5] The letters published in the San Francisco district form probably a truer index of the attitude of the member state banks because of the greater number of banks questioned and the extent of the territory covered. The greatest dissatisfaction was evident among small member institutions located in agricultural or live stock raising districts.

The Journal of the American Bankers' Association in 1919 published statements from 75 state bank and trust company members regarding the advantages of membership. The result was very favorable to the federal reserve system.[6] The publication of these letters probably induced the entrance of a number of institutions whose officers had previously been doubtful.

As time went on, however, there came a slackening in the campaign to persuade more state institutions to join. It was realized that any large influx of new members was out of the question. Many of the officers of the federal reserve banks felt that the state institutions in some sections had over-extended loans during 1919 and 1920 and would be undesirable members. The officers of some reserve banks found their time absorbed by other matters, because of the critical situation in which many member institutions had become involved. Some applications for membership were rejected because the condition of the applying institutions was found to be unsound. Many state bankers became definitely hostile because of the campaign to enforce par

[5] Federal Reserve Bank of San Francisco. State Bank Members. Their Experience in the Twelfth District.

[6] *Journal* A. B. A., June 1919 p. 660; August, 1919, p. 67.

remittance. Even under these conditions 204 new state bank and trust company members were enrolled during 1921.[7]

Among the losses preventing the complete gain from new members appearing in the 1921 total were: consolidations, mergers and conversions, 34; withdrawals 18; suspensions 12; insolvencies 1; liquidations 5; and absorption by nonmembers, 4. Total losses, 74. Three national banks were converted into state members during the year.

The high point in membership of state institutions was reached during the middle of 1922 when 1,657 were registered. Only 95 new state banks and trust companies entered during that year, so that the growing number of changes resulting in a decline in membership found the number of members on December 31, 1922, only 25 larger than the previous year. These changes were consolidations, mergers and conversions, 40; withdrawals, 13; liquidations, 9; insolvency, 7; suspensions, 2; and absorption by nonmembers, 1. The decline in members, starting in the latter half of 1922, was halted temporarily in the fall when

[7] The total membership of these institutions on December 31, 1921 is shown by the following table:

DECEMBER 31, 1921 (Amounts in thousands of dollars)

Federal Reserve District	Number	Capital and Surplus	Resources
Boston	40	$ 75,350	$ 724,523
New York	133	365,377	3,734,967
Philadelphia	51	76,417	389,520
Cleveland	115	146,812	1,019,144
Richmond	66	25,589	153,148
Atlanta	127	45,642	333,829
Chicago	377	187,183	1,769,952
St. Louis	105	53,111	417,959
Minneapolis	135	14,398	126,896
Kansas City	44	13,704	151,183
Dallas	202	21,711	124,654
San Francisco	219	85,369	959,085
Total	1,614	$1,110,663	$9,904,860

membership again increased to 1,657 on October 31st. Since that date the decline has been continuous.

The district membership of state banks and trust companies, at the approximate high point, June 30, 1922, is shown by the following table:[8]

(Amounts in thousands of dollars)

District	Number	Capital	Surplus	Resources
Boston	40	$ 38,056	$ 41,659	$ 809,863
New York	132	185,905	182,890	4,252,126
Philadelphia	56	27,634	50,864	411,575
Cleveland	117	71,659	82,585	1,151,492
Richmond	69	16,971	10,421	178,387
Atlanta	141	29,419	18,271	351,116
Chicago	381	106,202	89,092	1,970,526
St. Louis	117	34,453	22,639	458,880
Minneapolis	138	10,417	4,275	135,357
Kansas City	43	9,735	3,696	160,110
Dallas	199	13,825	5,731	113,536
San Francisco	215	61,485	23,685	1,033,114
Total	1,648	$ 605,761	$ 535,806	$11,026,082

By the end of the year state bank and trust company membership had declined to 1,639. But resources of these members had increased to almost twelve billion dollars.[9]

The following table gives some comparative statistics regarding members and nonmembers on June 30, 1922:

	Number	Capital and Surplus (Approximate)	Resources
All banks in the United States	30,325	$5,600,000,000	$50,150,000,000
National Banks	8,244	2,358,400,000	20,700,000,000
State Bank and Trust Company members	1,648	1,141,600,000	11,025,000,000
All member banks	9,892	3,500,000,000	31,725,000,000
Eligible non-members	9,678	1,209,000,000	8,985,000,000
Non-eligible non-members	10,755	891,000,000	9,440,000,000

The figures for the same date given in 12 Federal Reserve Board, 1925, p. 127 are different. They give total banks of 30,389 with resources of $50,425,367,000. Such differences are very common in statistics issued by the board.

[8] 9 Federal Reserve Board, 1922, p. 171.

[9] *Ibid.*, p. 29.

The Federal Reserve Board estimated that 78 per cent of the resources of all eligible banking institutions and 63 per cent of the total banking resources of the country were included in the system in 1922. The state member institutions controlled 32.6 per cent of the capital and surplus, and 34.7 per cent of the resources of the system.

Of the state bank and trust companies, with a combined capital and surplus of $1,000,000 or over on June 30, 1922, 205 were members while 135 had not joined.[10]

[10] The following table shows where the eligible non-member banks were located:

(Amounts in thousands of dollars)

District	Number	Capital	Surplus	Resources
Boston	177	$ 26,629	$ 20,223	$ 454,089
New York	284	60,558	70,277	1,181,694
Philadelphia	329	69,810	67,172	766,775
Cleveland	670	67,539	58,012	854,981
Richmond	804	81,020	46,267	775,120
Atlanta	754	45,407	18,658	420,023
Chicago	2,469	165,440	69,590	1,974,446
St. Louis	1,141	61,412	26,259	566,468
Minneapolis	849	38,112	12,268	442,429
Kansas City	1,083	51,121	17,238	484,428
Dallas	511	29,838	8,537	220,450
San Francisco	607	63,755	25,919	842,677
Total	9,678	$ 760,695	$ 448,420	$8,983,580

It will be observed that almost one-half of the eligible banking institutions remaining outside were in the three Middle West Districts, Chicago, St. Louis, and Kansas City. This is the section of the country where the small banks exist in large numbers.

CHAPTER X

DECLINE OF STATE BANK MEMBERSHIP SINCE 1922

THE decline in membership of state banks and trust companies which began in 1922 has continued since that date. Only 209 joined in the five years from 1923 to 1927. Membership by June 30, 1928, had fallen to 1,244, over 400 less than in 1922. The resources of these members, however, have steadily increased, so that a larger proportion of the total resources of the system was controlled by the member state institutions in 1928 than 1922. While the resources of the national bank members have also increased, the proportionate power of these banks is not now so great as in 1922, but is greater than it was in 1926 because of the fact that the Bank of Italy, since March, 1927, has been a national bank. The table on page 147 gives the various causes for the decline in state bank membership since 1922.[1]

REASONS FOR DECLINE IN MEMBERSHIP OF STATE BANK AND TRUST COMPANIES

The following table will show the reasons why state bank and trust company membership has declined:

[1] For a detailed treatment of the reasons for the decrease in membership see Tippetts, C. S., "The Decline of Membership in the Federal Reserve System," *Journal of Political Economy,* April, 1928, pp. 185–211. Some of the material from this article is contained in the present chapter.

NUMBER OF BANKS

	1919	1920	1921	1922	1923	1924	1925	1926	1927	Total
State Bank membership beginning of year	930	1181	1481	1614	1639	1595	1544	1441	1354	
Total Additions	289	342	207	97	74	46	43	44	34	1176
Admission of state banks	284	336	204	95	66	41	40	33	29	1128
Admission of national banks	5	6	3	1	6	3	1	7	2	34
Absorption of national banks	(13)	(12)	(28)	(39)	(23)	(22)	(12)	(19)	(1)	169
Absorption of nonmembers	....	....	....	....	....	(6)	(7)	....	....	13
Resumption following suspension	....	....	....	1	2	2	2	....	3	10
Total Losses	38	42	74	72	118	97	146	131	113	831
Voluntary liquidation	4	3	3	8	4	5	1	4	1	33
Suspension or insolvency	....	3	16	10	33	37	29	36	33	197
Merger between state members	3	9	10	12	16	9	11	12	14	96
Absorption by national banks	4	2	7	7	5	8	6	6	17	62
Conversion to national banks	12	10	17	21	29	6	45	8	8	156
Absorption by nonmember banks	2	3	2	1	....	5	14	4	6	37
Conversion to nonmembers	....	....	....	....	1	1	1	2	8	13
Withdrawal	9	12	19	13	29	26	39	59	26	232
Other decreases (nonpayment on federal reserve stock)	4	....	....	....	1	....	....	....	....	5
Net increase (+); net decrease (–)	+251	+300	+133	+25	–44	–51	–103	–87	–79	
Membership, end of year	1181	1481	1614	1639	1595	1544	1441	1354	1275	

In order to obtain an idea of the growth since 1920 of the banking power contained in the federal reserve system, certain figures are available for purposes of comparison. They will be given in the following tables:

Date	Number	Capital and Surplus (In Thousands of Dollars)	Resources (In Thousands of Dollars)
All Member Banks[2]			
June 30, 1920	9,399	3,197,470	32,194,301
June 30, 1921	9,745	3,416,429	29,639,259
June 30, 1922	9,892	3,500,000	31,725,000
June 30, 1923	9,856	3,629,997	33,795,326
June 30, 1924	9,650	3,699,592	35,777,256
June 30, 1925	9,538	3,836,547	39,105,025
June 30, 1926	9,375	4,069,049	40,845,189
June 30, 1927	9,099	4,304,079	42,810,192
June 30, 1928	8,929	4,700,912	45,091,849
Member National Banks			
June 30, 1920	8,025	2,209,274	22,187,459
June 30, 1921	8,150	2,298,981	19,630,124
June 30, 1922	8,244	2,358,400	20,700,000
June 30, 1923	8,236	2,398,167	21,502,202
June 30, 1924	8,079	2,412,848	22,555,273
June 30, 1925	8,066	2,486,853	24,338,831
June 30, 1926	7,972	2,610,133	25,302,608
June 30, 1927	7,790	2,729,463	26,566,508
June 30, 1928	7,685	3,011,691	28,492,904
State Bank and Trust Company Members			
June 30, 1920	1,374	988,196	10,006,842
June 30, 1921	1,595	1,117,448	10,009,135
June 30, 1922	1,648	1,141,600	11,025,000
June 30, 1923	1,620	1,231,830	12,293,124
June 30, 1924	1,570	1,286,744	13,221,983
June 30, 1925	1,472	1,349,694	14,766,194
June 30, 1926	1,403	1,458,916	15,542,581
June 30, 1927	1,309	1,574,616	16,243,684
June 30, 1928	1,244	1,689,221	16,598,945

[2] On June 30, 1921, there were 30,812 banks in the United States with capital and surplus of $5,445,993,000 and resources of $49,671,390,000. On June 30, 1926, there were 28,081 banks with capital and surplus of $6,700,000,000 and resources of $64,587,000,000. By June 30, 1928 the total number of banks had declined to 26,000.

The relative strength of the state banks, national banks, and federal reserve system itself is estimated in the following tables:

Date	Percentage of all banks in the country which hold national charters	Percentage of country's banking resources held by national banks
June 30, 1920	26.62	41.80
June 30, 1921	26.45	39.52
June 30, 1922	27.12	41.07
June 30, 1923	27.29	39.79
June 30, 1924	27.54	39.47
June 30, 1925	27.96	39.22
June 30, 1926	28.38	39.19
June 30, 1927	29.08	39.00
June 30, 1928	29.61	....

	Percentage of resources of all members of the federal reserve system held by national banks	Percentage of all deposits of members of federal reserve system held by national banks
June 30, 1920	68.91	67.59
June 30, 1921	66.23	65.19
June 30, 1922	65.25	63.94
June 30, 1923	63.62	62.81
June 30, 1924	63.04	62.11
June 30, 1925	62.24	61.38
June 30, 1926	61.94	61.18
June 30, 1927	62.05	61.56
June 30, 1928	63.19	62.84

	Percentage of all bank loans and investments in the country made by national banks	Percentage of deposits, exclusive of bank, held by national banks
June 30, 1920	42.35	37.86
June 30, 1921	40.14	36.38
June 30, 1922	39.43	36.61
June 30, 1923	38.60	35.78
June 30, 1924	37.74	35.60
June 30, 1925	37.58	35.87
June 30, 1926	37.28	35.80
June 30, 1927	37.67	36.63
June 30, 1928	38.55	37.28

Date	Percentage of all deposits in the country held by national banks
June 30, 1920	41.10
June 30, 1921	39.33
June 30, 1922	39.67
June 30, 1923	38.17
June 30, 1924	38.44
June 30, 1925	38.28
June 30, 1926	38.31
June 30, 1927	38.60

Date	Percentage of resources of members of the federal reserve system furnished by state bank members	Percentage of deposits in all members of the federal reserve system held by state bank members
June 30, 1920	31.09	32.41
June 30, 1921	33.77	34.81
June 30, 1922	34.75	36.06
June 30, 1923	36.38	37.19
June 30, 1924	36.96	37.89
June 30, 1925	37.76	38.62
June 30, 1926	38.06	38.82
June 30, 1927	37.95	38.25
June 30, 1928	36.81	37.16

Date	Percentage of all country's banking resources held by members of the system	Percentage of all banks in the country that are members of the system	Percentage of all bank deposits in the country held by members of the federal reserve system
June 30, 1920	60.6	31.18	60.82
June 30, 1921	59.67	31.62	60.34
June 30, 1922	62.9	32.5	62.05
June 30, 1923	62.5	32.6	61.15
June 30, 1924	62.6	32.88	61.91
June 30, 1925	63.31	33.02	62.36
June 30, 1926	63.24	33.31	62.38
June 30, 1927	62.85	33.98	62.9
June 30, 1928	....	34.44	....

	Percentage of all bank loans and investments in the country made by member banks
June 30, 1920	61.66
June 30, 1921	60.85
June 30, 1922	60.73
June 30, 1923	60.96
June 30, 1924	60.09
June 30, 1925	60.05
June 30, 1926	60.76
June 30, 1927	60.97
June 30, 1928	61.26

It may next be asked what proportion of the resources of all banks eligible for membership are held by the system. This is a significant comparison for membership is closed to all banks not possessing certain qualifications. On June 30, 1924, there were 6,100 banks with resources of $9,782,000,000 which were not under any conditions eligible for membership on that date. 3,965 nonmember banks with resources of $1,134,000,000 were eligible only under the provisions of the Agricultural Credits Act of March 4, 1923. These were banks which had a capital equivalent to 60 per cent of that required of national banks in that locality, and which must, upon joining, increase their capital to that required of national banks within five years. Other nonmember banks, to the number of 9,635 with resources of $10,452,000,000, had sufficient capital and were eligible under the original provisions of the Federal Reserve Act.

Before 1919 changes resulting in a decrease in state bank membership were insignificant, only ten losses having occurred up to that date. The reasons given for these losses were: mergers between state bank members, 1; absorbed by a national bank, 1; converted into a national bank, 2; withdrawal, 1; non-payment for federal reserve stock, 5.

At the end of 1914 there had been eight state bank and trust company members. During the next four years 930 such banks joined and two national banks converted into

state members. Had all the banks which had at one time been members remained in the system, there would have been approximately 2,100 state bank and trust company members instead of 1,244 by the middle of 1928. In addition, 169 national banks were absorbed by state members, thirty-four nationals have converted into state members, and thirteen nonmembers consolidated with state members from 1919 to 1927.

The chief reasons why all one-time state bank members were not retained were the following: withdrawals, 232; conversion into national banks, 156; suspension or insolvency, 197; consolidations of state members, 96; and absorptions by national banks, 62.

The rate at which new members enrolled fell off decidedly after 1922. Only eighty-one joined during 1924 and 1925, and sixty-two during 1926 and 1927. To maintain the membership at a stable figure new members to the number of over 100 would have to enter every year. This is clearly out of the question. Therefore, a small decline in state bank and trust company membership may be expected for some time to come.

Some of the reasons for this decrease are not to be regretted. For example, 156 state members allied themselves even more firmly with the system by becoming national banks during the period from 1915 to 1927. While this is a loss from the point of view of state bank membership, it is a decided gain in the end as it increased the permanent strength of the federal reserve system. The national banks are the backbone of the system and any increase in their numbers is a cause for satisfaction. Likewise, there need be no mourning over the loss occasioned when 158 state members consolidated with other members, or were absorbed by national banks. These banks were not lost to the system. The reasons for decline which are to be regretted are to be found in the 233 withdrawals and the 197 suspensions. This situation will be discussed shortly.

A great disparity is noticed between various districts

in the matter of furnishing gains or losses. Boston for example, has maintained an almost stable state bank membership since the first of 1919. While only eight state banks and trust companies have joined in that district since 1920, there has been only one withdrawal and no insolvencies. New York and Philadelphia are the only districts with a larger membership at the end of 1927 than at any previous time. With the exception of one year, 1921, when a net loss of one occurred, New York has presented a steadily increasing list of members. Philadelphia, alone of all the districts, presents an unbroken record of increase with no withdrawals. That district registered a clear gain of from six to ten annually every year from 1918 to 1926. Cleveland and St. Louis offered an unbroken record of gain until 1925, the former suffering a net loss of three and the latter a loss of two in that year.

Dallas, San Francisco, Minneapolis, and Chicago have suffered the greatest losses. While Dallas showed a net loss of fifty-six in 1925, it should be pointed out that thirty-eight of this figure come from the conversion of state into national banks.[3]

The districts with the smallest gain in new state membership since 1923 are: Richmond, with one enrollment since that year; Kansas City and San Francisco, with three each; Atlanta and Boston with four each; and Minneapolis, with five.

State Bank Withdrawals

The situation regarding withdrawals has caused considerable uneasiness during the past few years. The following table shows the comparison between the districts as to number of withdrawals.[4]

[3] These comparisons are taken from the table of changes in 12 Fed. Res. Board, 1925, pp. 176–183, and 13 Fed. Res. Board, 1926, pp. 188–189.

[4] See article, Tippetts, C. S., "State Bank Withdrawals from the Federal Reserve System," *American Economic Review*, Sept., 1923, pp. 401–410. Some of the material in this section on withdrawals is adapted from that article.

	1916	1919	1920	1921	1922	1923	1924	1925	1926	Total
1. Boston	....	....	....	....	....	....	1	....	....	1
2. New York	....	....	3	2	....	....	2	2	....	9
3. Philadelphia	....	....	....	....	....	....	....	....	....	0
4. Cleveland	....	1	....	1	1	1	4	3	3	14
5. Richmond	....	....	....	1	2	3	2	2	....	10
6. Atlanta	....	3	....	....	2	3	1	4	8	21
7. Chicago	....	3	7	....	3	7	4	3	13	40
8. St. Louis	....	1	....	....	1	3	1	4	4	14
9. Minneapolis	....	....	2	1	3	5	....	9	13	33
10. Kansas City	....	....	....	11	1	4	....	1	5	22
11. Dallas	1	1	....	....	....	1	5	5	8	21
12. San Francisco	....	....	....	3	....	2	6	6	5	22
Total	1	9	12	19	13	29	26	39	59	207

The states in which withdrawals were heaviest prior to 1926 were: Illinois 11, Nebraska 10, Wisconsin 10, Idaho 8, Oklahoma 8, Minnesota 7, Texas 7, Florida 6, Michigan 6, New York 6, Ohio 6, Indiana 5, North Carolina 5, Utah 5, Arkansas 4, California 4, Georgia 4, Iowa 4, Louisiana 4, and Tennessee 4.

Two-thirds of the retiring banks had a capital of $50,000 or less. Only twenty out of the entire 207 had a capital of over $200,000. The effect upon the resources of the entire system has not been important, less than one per cent having been lost in this way.

The largest institutions yet to withdraw are the following:

	Capital	Surplus	Resources
San Francisco Savings & Loan Society	$1,000,000	$2,600,000	$80,520,000
Dayton (Ohio) Savings & Trust Co.	600,000	600,000	17,550,000
Midwest Reserve Trust Company, Kansas City, Mo.	2,000,000	215,000	15,209,000
Bridgeport (Conn.) Trust Company	1,000,000	300,000	10,315,000
Continental Trust Co., Washington, D. C.	1,000,000	100,000	4,492,000

These five banks carried out with them in resources $128,000,000. The first two by themselves were responsible

for almost one-third of the resources lost by withdrawals since the beginning of the system. It will be observed that these institutions are either trust companies or savings banks. Their departure, therefore, is not a serious blow to the system since these are types of banking institutions whose membership is not essential, and for whom membership has little advantage. The retirement of the Continental Trust Company of Washington cannot, however, be observed without regret. This was the first trust company to join the system.

The foregoing figures show clearly that withdrawals are not, as some have supposed, a recent development. They have been proceeding with a fair degree of regularity since 1919. The withdrawing banks have been located for the most part in the Middle West and South, the Eastern and Pacific coast states suffering few such losses. Many banks which entered in 1917 and 1918 claimed they were doing so for patriotic reasons to assist in winning the war. A number stated that they expected to withdraw as soon as the emergency was over. A certain number of retirements had to be expected in the inevitable shaking down process following the war. In fact, it is rather surprising that the number of losses in the years immediately following the war were not larger.

Various reasons for severing relationship with the system have been given.

1. Probably the reason most frequently met for giving up membership has been the non-payment of interest on the reserve balances kept with the federal reserve bank. The first bank to withdraw, The First Guaranty State Bank of Pittsburg, Texas, believed that membership was too expensive because of this loss.[5] The Exchange Bank of Kentucky of Mount Sterling, Kentucky, is another example. In a letter to the Federal Reserve Bank of Cleveland on November 9, 1918, the cashier of this bank stated that his

[5] *Fed. Res. Bull.*, May 1, 1917, p. 371.

institution had come in for the period of the war only and expected to withdraw as soon as the war was over because of the non-payment of interest on its reserve.[6] It withdrew early in 1919. The Potlatch State Bank of Potlatch, Idaho, is another bank which joined because of "a possible moral obligation" but found the non-payment of interest on its reserves so disadvantageous that it withdrew early in 1921.[7] Whether or not the non-payment of interest actually results in a loss to the member institutions is discussed more fully in another connection. It seems certain, however, that a number of institutions have really found membership expensive for this reason.

2. The fact that checks in transit from country to city banks for collection may, under most state laws, still count as legal reserve the moment they are mailed is another inducement to nonmembership.

3. Several banks withdrew because easier money conditions removed the necessity for borrowing from the federal reserve banks. They claimed that their correspondents could take care of all their needs. Many large city banks have never been enthusiastic about their country correspondents joining the system or retaining membership. Many members have never borrowed from the reserve banks at all.

4. Another reason which has sometimes been given is the hostility which was stirred up by the campaign for universal nation-wide par collection of checks. However, a bank gained little by withdrawing from membership unless it meant to get off the par list as well.

5. Several banks withdrew because of laws passed in their respective states for the guaranty of bank deposits. In certain states the public felt that banks were not safe unless they were members of the state guaranty system.

[6] *The Answer.* Letters from state bank members published by the Federal Reserve Bank of Cleveland, 1918. Letter No. 11.

[7] State Bank Members. Their Experiences in the Twelfth Federal Reserve District. Letter 29. Fed. Res. Bank of San Francisco.

Some banks felt that they could not afford to comply with such state laws and retain federal reserve membership also.

6. Some banks claim that membership involves too much red tape, duplication of supervision by state and federal authorities, and too many reports and examinations.

7. A reason for withdrawal which is frequently overlooked is that certain of the member state institutions have been made to understand that their membership is no longer desired because of their unsound condition. An example of this kind is the Bank of Goltry of Goltry, Oklahoma, which was closed by the state banking officials after it had withdrawn.[8] The Federal Reserve Board reports eleven compulsory withdrawals, five in 1921, one in 1924, two in 1925, and three in 1926.

Any generalization as to the cause for withdrawals is difficult to make. The reasons most frequently given are the non-payment of interest on the reserve balances, satisfactory assistance given by correspondents, and the absence of need of resorting to the federal reserve banks for assistance. In many cases withdrawal has been caused by a combination of a number of the foregoing reasons, and some apparent withdrawals were forced retirements.

A decline in the number of member state banks and trust companies in the federal reserve system is not a cause for wonder when it is remembered that the nonmembers have obtained practically all the advantages of membership through their correspondents who are members, and that frequently the city banks have encouraged their country correspondents to remain outside. Furthermore, from July, 1921, until June, 1923, the Federal Reserve Board permitted member institutions to act as agents for nonmembers in rediscounting paper at the reserve banks without obtaining special permission. While this may have been necessary as an emergency measure, it certainly removed for a period one of the chief reasons for nonmember institutions apply-

[8] 12 Fed. Res. Board, 1925, p. 176.

ing for membership. While the rate at which state institutions have been entering the system has decreased considerably, it should be emphasized that since 1920 the federal reserve banks have made little or no campaign to encourage enrollment; that a large number of banks have been discouraged from applying because of their financial condition; that some applications have been rejected; and that credit conditions have at least until the latter part of 1927, been easy. It may be added that membership is not likely to show a large increase so long as nonmembers may share as widely in the benefits as they do at present without sharing in the responsibility which membership entails.

It has been contended at times recently that the federal reserve system is losing prestige. Two tendencies have been mentioned as evidence in this respect. One is the decline in state bank membership. The other is the decline in national bank membership. It is true that nearly 250 state banks have withdrawn. It is true that the number of national banks declined from 8,244 on June 30, 1922, to 7759 at the end of 1927. It is true also that the national banks in 1927 controlled a smaller proportion of the country's banking resources and deposits than in 1920. But there are offsetting factors as well. For example, a larger proportion of all banks held national charters in 1927 than in 1920. While 232 state banks were withdrawing, 156 others attached themselves more firmly to the system by becoming national banks. While 287 national banks converted into nonmembers and 329 were absorbed by nonmembers from 1915 to 1927, yet during the same period 770 nonmember state banks became national banks and entered the system directly, and 1,435 new banks were organized under national charters.

National Banks

In order to get a picture of what is happening to the national banks, the following table of changes is prepared:

	1919	1920	1921	1922	1923	1924	1925	1926	1927	Total
Membership, first of year	7,762	7,885	8,125	8,165	8,220	8,179	8,043	8,048	7,906	
Total Additions	245	354	197	225	190	131	239	147	131	1859
Primary organizations	171	236	111	76	93	89	120	108	82	1086
Conversion of state members	11	11	17	20	30	6	45	8	8	156
Conversion of nonmembers	62	103	58	110	56	19	69	22	32	531
Resumption following suspension	1	4	11	19	11	17	5	9	9	86
Total losses	122	114	157	170	231	267	234	289	278	1862
Merger between national banks	36	29	38	48	41	44	42	68	96	442
Absorption by state members	13	12	28	39	23	22	12	19	1	169
Conversion to state members	6	6	3	1	7	2	1	7	3	36
Voluntary liquidation	5	11	9	15	20	27	12	8	8	115
Suspension and insolvency	3	18	54	38	92	128	118	124	91	666
Absorption by nonmembers	20	22	19	18	35	30	28	40	49	261
Conversion to nonmembers	38	16	6	9	13	14	21	23	12	152
Other decrease	1	....	....	2	....	....	....	....	....	3
Net change	+123	+240	+40	+55	-41	-136	-15	-143	-147	-3
Membership, end of year	7,885	8,125	8,165	8,220	8,179	8,043	8,048	7,906	7,759	

A large proportion of the new national charters granted during the past few years was due to dissatisfaction of existing state banks with state laws for the guarantee of bank deposits. For example in Oklahoma in 1922 there were 72 conversions of state into national banks. Similar conversions occurred in large numbers in Texas in 1925 for the same reason. (*Fed. Res. Bull.*, Sept., 1925, p. 631.)

This table reveals the fact that the largest single factor in the decline of the national banks is the large number of failures, 666. Mergers between national banks are responsible for the loss of 442. Nonmember banks absorbed 261, state member banks absorbed 169, and 152 converted into nonmember state banks.

Undoubtedly there is a growing feeling among bankers that a national charter is not particularly advantageous, that the national banks are unduly burdened with restrictions as compared to their state bank competitors. This has been greatly remedied by the McFadden-Pepper Bank Act of 1927. This act probably prevented a wholesale conversion of national banks into state institutions. The provisions of this Act will be discussed in Chapter XV.

Whatever may be the future of the national banks, it is evident that the federal reserve system as a whole is maintaining its control over the banking resources of the country.

Agriculture Credits Act of 1923

Following the economic depression of 1921 the advisability of a larger state bank and trust company membership was widely discussed. It was argued that agricultural interests would have suffered much less from stringency of bank credit during the depression had there been a larger membership among the country banks. It was pointed out that only about 15 per cent of all eligible state banks had joined. It was felt that a larger membership would have made the resources of the federal reserve system more readily available for agriculture.

Mr. Gray Silver of the American Farm Bureau Federation testified before the Joint Commission of Agricultural Inquiry that one reason why the farmers had not been able to secure more credit during 1920 and 1921 was because there were so few country banks in the federal reserve system. For that reason, said Mr. Silver, the organization

which he represented was urging these banks to join.[9] Mr. Silver assumed that the farmers needed additional credit of the kind which the federal reserve banks could furnish. But there is evidence to the effect that it would have been better for the farmer had he received less instead of more credit previous to 1920.

The report of the Joint Commission of Agricultural inquiry also asserted that the fact that so many banks remained outside was a very serious defect in our banking system. This report stated: [10]

> "A system of independent banking makes difficult the carrying out of any uniform policy, either of liberality or of curtailment of credit. It means that the system must be subject to all the individual differences of management and of policy of the 30,000 banks which comprise the system. It makes impossible the full utilization of the resources of some banks in the locality to relieve a situation where other banks in the same locality are extended to the full limit consistent with safety to their depositors." The banks which remain outside of the Federal Reserve System "are without direct access to the general reservoir of credit, consequently must rely for the expansion necessary in times of stress or business expansion upon the accommodations which it is possible to secure from their correspondents. These banks contribute little to the general reserves of the country, as those reserves are now represented principally by deposits in the Federal Reserve banks. Consequently, if they are permitted to borrow either directly or indirectly from the Federal Reserve banks in times of stress or business expansion they must do so at the expense of reserves contributed by the banks which are members of the Federal Reserve System."

Mr. Eugene Meyer, Jr., managing director of the War Finance Corporation, stated before the House Committee on Currency and Banking that the federal reserve system had not developed as Congress had hoped it would, inas-

[9] Hearings before the Joint Commission of Agricultural Inquiry, part 6, pp. 53–4. 67th Congress, 1st session, 1921.

[10] Report of the Joint Commission of Agricultural Inquiry, part II Credit, Ch. VIII, p. 146. Washington: Govt. Printing Office, 1922.

much as it had been the intent of that body to bring all eligible banks in. He also stated:[11]

> "The failure of the eligible country banks to become members of the Federal Reserve System has denied to many agricultural communities the full benefit of the system. The experience of the War Finance Corporation administering the Agricultural Credits has demonstrated conclusively that, in times of stress, the nonmember banks in the country districts are in greatest need of access to a central reservoir of credit. Approximately 85 per cent of the banks to which the Corporation has made loans are state institutions and only about 15 per cent are National banks. In terms of dollars the loans of the Corporation to State banks constitute 80 per cent of the whole."

It might be doubted, however, whether membership in the system would have relieved this situation to any great extent. What many of the farmers wished was credit for a longer period than the six months limit established for agricultural and livestock paper eligible for rediscount at the federal reserve banks.

One result of this agitation was the Agricultural Credits Act, approved March 4, 1923, which attempted to make membership more attractive to country banks by extending the limit of maturity of notes, drafts, and bills of exchange drawn for agricultural or livestock purposes which are eligible for rediscount at the federal reserve banks from six months to nine.[12] Some authorities at the time believed this to be a mistake. Admitting that six months was too short a maturity for much of the agricultural and livestock paper, they felt that it might result in an impairment of the liquidity of assets which should be an essential feature of the federal reserve system. The extension of the maturity of such paper was not among the recommendations of the Joint Commission of Agricultural Inquiry. On the

[11] Hearings before the House Committee on Currency and Banking on Bills S. 4280 (H. R. 13033), Statement of Mr. Eugene Meyer, Jr., Jan. 31, 1923, pp. 43-4, 54-6.

[12] Agricultural Credits Act of 1923, Title V, Section 404. This amends Section 13 of the Federal Reserve Act.

contrary, this Commission expressed the belief that "It is the very essence of the proper functioning of the Federal Reserve System and the protection of its note issue that the assets of the Federal Reserve banks be confined to investments of a self-liquidating nature and of these shorter maturities".[13]

However, the danger from this amendment was offset by a clause in the same act giving the Federal Reserve Board power to limit the amount of such paper that a reserve bank might rediscount to a certain per cent of the assets of the reserve bank. As a matter of fact, only an insignificant amount of such paper has been rediscounted with the reserve banks. During 1925 out of a total of rediscounts by all reserve banks amounting to \$32,500,000,000 only \$11,600,000 had a maturity of between six and nine months. This was less than .04 of one per cent. The average maturity of all rediscounted paper held by the federal reserve banks in 1925 was about 8 days; in 1924 it was about 12 days.

In one provision of the Agricultural Credits Act is seen an attempt to put nonmembers at a disadvantage. Section 401 states that no federal reserve bank may rediscount for a federal intermediate credit bank agricultural or livestock paper bearing the signature or indorsement of any nonmember bank or trust company which is eligible for membership in the system.[14] No valid objection can be raised to this stipulation for the advantages of the federal reserve system should not be thrown open to banks who refuse to share in the burdens of membership.

It was felt at the time of the enactment of this act that an investigation should be made of the reasons for the reluctance of the state banks and trust companies to enter the federal reserve system. Accordingly, there was created

[13] Report of the Joint Commission of Agricultural Inquiry, Part II, Credit, p. 148; Part I, The Agricultural Crisis and its Causes, pp. 10–11.

[14] Agricultural Credits Act of 1923, Title IV, Section 401.

a joint congressional committee of members of the House and the Senate to make such an investigation.[15] This commission was directed to ascertain why so many banks in agricultural sections remained aloof. It was also directed to report upon the effect on agricultural regions of having so many nonmember banks.

This committee held extensive hearings in Washington during October, 1923. During November it held hearings in Chicago, Omaha, Kansas City, St. Louis, Little Rock, Dallas, Houston, New Orleans, Montgomery, and Atlanta. At these hearings many prominent economists and bankers appeared. Many recommendations were made to this commission.

Although directed to render a report by January 1, 1924 the commission has never done so. In January of 1924, claiming more information was needed, it secured an extension of time to June 30 of that year.[16] The report has never been submitted. The hearings have never been published. Another governmental investigation necessitating considerable expenditure of public funds seems to have been forgotten. Some of the testimony given before this commission will be discussed in Chapter XII on Validity of Objections to Federal Reserve Membership. What it wishes to report, if it ever does so report, is unknown; but it is highly doubtful if any new facts, hitherto unknown to close students of the question, will be revealed if the document ever does appear.

State Banks Eligible for Membership

One way in which it was thought membership might be increased was by increasing the number of eligible banks. Accordingly, approximately 4,200 additional banks were made eligible in 1923 by modifying the capital requirements.[17] The Agricultural Credits Act of March 4, 1923

[15] Agricultural Credits Act of 1923, Title V, section 506.
[16] Report No. 86 on H. J. Res. 151. 68th Congress, 1st Session, H. R.
[17] *Fed. Res. Bull.*, Nov., 1923, p. 1177).

amended the Federal Reserve Act to permit state banks and trust companies possessing a capital of at least 60 per cent of that required of national banks in that locality to join under rules and regulations laid down by the Federal Reserve Board, provided they agreed to increase their capital to that required of national banks within a period set by the Federal Reserve Board, subject to the requirement that at least 20 per cent of the difference must be made up every year.[18] The Federal Reserve Board designated five years as the period in which the change in capital must be made if the institution is allowed to enter. That this amendment would not, however, encourage many additions to membership was evident from the beginning from the fact that of the total membership on December 31, 1922 only 294 had a capital as small as $25,000 the minimum required for a national charter. Less than a dozen banks out of the 4,200 made eligible in this way have become members under these conditions.[19]

This change in the law permitting institutions which were formerly ineligible to enter came as a result of a long period of agitation. The Federal Reserve Board was asked in 1917 to state its opinion upon the advisability of such a change. It replied that it would not be fair to national banks to lower the requirements for the state institutions. With regard to the advisability of lowering the capital requirements for national institutions so as to make more state institutions eligible, the Board was not ready to express an opinion.[20] Many bankers associations had at various times expressed the belief that the law should be changed to let in the smaller institutions. The Minnesota

[18] An act to provide additional credit facilities for the agricultural and live stock interests of the United States, to amend the Federal Farm Loan act; to amend the Federal Reserve Act and for other purposes. Public No. 503, 67th Congress, Title XXIV, section 401. Text also in *Fed. Res. Bull.*, March 1923, pp. 304–15.

[19] This result bears out a prophecy made by the present writer in an article "State Bank Withdrawals from the Federal Reserve System," *American Economic Review*, Sept. 1923, p. 410.

[20] *Fed. Res. Bull.*, Oct. 1, 1917, p. 764.

Council of State Banking Institutions, organized in August, 1918, advocated lowering the capital requirements for membership as only 211 out of 1,124 state institutions were at that time eligible.[21] The Executive Committee of the State Bank Section of the American Bankers' Association gave its hearty approval to the amendment as it finally appeared in the Agricultural Credits Act of 1923.[22] But it should be noted that banks and trust companies permitted to join under this amendment must eventually possess the same capital as national banks, so the change is not so radical as it seems. One reason why the change will never add many new members is that it is the small institution that is generally most dissatisfied with the federal reserve system. It is among banks of this class that the complaint most frequently arises that membership is expensive because of the non-payment of interest on reserve balances.

The latest available figures published by the Federal Reserve Board give in June, 1924, a total of 13,598 eligible banks which are not members. They had a capital of approximately $900,000,000, surplus of approximately $600,000,000, and resources of $11,600,000,000. From this list should be subtracted, however, to secure a comparison with former years, those banks which were made eligible by the amendments contained in the Agricultural Credits Act of 1923. There were in June, 1924, 3,965 such banks. Of these 3,614 do not have the required $25,000 capital. To join under this amendment such banks must have at least $15,000 capital and agree to increase it to $25,000 within at most 5 years. Only five banks of this class were members in June, 1924. The number declined to three in 1925.

The following table outlines the situation:

[21] *Com. and Fin. Chron.*, Sept. 7, 1918, pp. 940–1.
[22] *Journal* A. B. A., May 1922, p. 735.

	Capital not less than $200,000. Population Over 50,000	Capital $100,000 to $199,999. Population 6,000–50,000	Capital $50,000–$99,999. Population 3,001–6,000	Capital $25,000–$49,999. Population Under 3,000	Total
Eligible Under Federal Reserve Act	559	989	889	7,196	9,633
Resources	$4,350,000,000	$2,238,000,000	$877,475,000	$3,000,000,000	$10,451,000,000

	Capital $120,000-$199,999. Population over 50,000	Capital $60,000–$99,999. Population 6,001–50,000	Capital $30,000–$49,999. Population 3,001–6,000	Capital $15,000–$24,999. Population under 3,000	Total
Number of banks made eligible in 1923 having 60% of capital required for national banks in that locality	120	115	116	3,614	3,965
Resources	$260,000,000	$113,700,000	$58,319,000	$701,900,000	$1,134,000,000

The important facts to be derived from this table are these:

1. Even if all the banks made eligible in 1923 should join, the gain to the federal reserve system in resources would be less than 3 per cent. The most desirable members of this group are the 354 banks with a capital of more than \$25,000. Even they, however, would bring in only about \$425,000,000 additional resources. The importance of this amendment then has been greatly magnified. The only advantage in passing it was to quiet the complaints of those who said that the capital requirements for state banks were too strict.

2. Out of the entire group of those originally eligible, the most desirable are the 559 with a capital of over \$200,000. Many of these banks should be members. They would add about 10 per cent to the resources of the system. Next to this group in desirability come the 989 eligible banks with capital of from \$100,000 to \$200,000. But there seems little chance of adding many of this group to membership in the next few years. Many of them, of course, are trust companies the membership of which is not so essential to the system or advantageous to themselves, unless they carry on an extensive commercial banking business.

Nonmember banks eligible under the original federal reserve act, distributed by districts were as follows in June, 1924:

		(Amounts in Thousands of Dollars)		
	Number	Capital	Surplus	Resources
Boston	178	$26,931	$22,873	$ 510,560
New York	314	79,900	86,848	1,371,474
Philadelphia	374	80,703	86,012	981,804
Cleveland	716	68,734	66,308	1,040,590
Richmond	814	82,657	54,374	869,885
Atlanta	786	49,981	22,256	534,332
Chicago	2,512	176,597	82,522	2,318,306
St. Louis	1,129	62,793	25,531	601,363
Minneapolis	719	31,494	10,761	413,901
Kansas City	1,032	47,498	15,895	505,114
Dallas	474	27,470	8,794	240,607
San Francisco	585	70,471	31,721	1,063,591
Total	9,633	$805,229	$513,895	$10,451,527

The distribution of membership of non-national banks by districts at the end of 1924 was:

DECEMBER 31, 1924

		(Amounts in Thousands of Dollars)	
Federal Reserve District	Number	Capital and Surplus	Resources
Boston	36	$ 72,495	$ 840,937
New York	144	431,281	5,939,782
Philadelphia	72	113,071	638,557
Cleveland	119	186,632	1,504,836
Richmond	62	33,001	249,693
Atlanta	128	48,808	470,053
Chicago	353	219,615	2,438,159
St. Louis	132	64,878	611,105
Minneapolis	100	9,504	100,376
Kansas City	33	11,918	150,319
Dallas	183	15,320	121,957
San Francisco	182	115,188	1,553,102
Total	1,544	$1,322,711	$14,617,876

By December 31, 1925 membership of state banks and trust companies, had dropped to 1,441 with Capital and Surplus of $1,393,000,000 and Resources of $15,586,000,000. The following table gives this membership by districts and makes a comparison with the nonmembers eligible in 1924:

	Members	Non-Members	
		Eligible Under Original Act	Additional Eligibles Under 1923 Amendment
Boston	38	178	14
New York	146	314	8
Philadelphia	82	374	60
Cleveland	116	716	111
Richmond	56	814	277
Atlanta	116	786	421
Chicago	347	2,512	592
St. Louis	130	1,129	624
Minneapolis	85	719	680
Kansas City	33	1,032	788
Dallas	127	474	247
San Francisco	165	585	143
Total	1,441	9,633	3,965

If eligibility is figured on the basis of those eligible under the original act, the federal reserve system as a whole, including national and non-national members, contained 77.4 per cent of the resources of all eligible banks in June, 1924. In 1922 the corresponding figure was 78 per cent. If figured on the basis of all eligible banking resources including those made eligible in 1923 the percentage in 1924 drops to 70.20.

The percentage of state banks and trust companies originally eligible included in the system June 30, 1922 was 17.03 per cent. On June 30, 1924 it was 16.3 per cent, a slight decline. Similar figures for resources in 1922 were 55 per cent; in 1924 it increased slightly to 55.8 per cent. If the computation is made for all eligible banks in 1924, only 10.4 per cent of all eligible banks were in the system.

But the resources of those made eligible in 1923 were so small that even including them the system still held 53.5 per cent of all eligible non-national banking resources.[23]

The proportion of non-national members in the system to all non-national banks in the country has been during the last five or six years about seven per cent.

The member state banks and trust companies were classified according to capital stock at the beginning of 1926 as follows:

Capital of[24]	Number	(Amounts in Thousands of Dollars) Capital	Resources
$25,000	239	$ 5,948	$ 73,175
$25,001 to $50,000	362	16,181	25,615
$50,001 to $100,000	280	25,615	396,720
$100,001 to $200,000	181	32,200	539,077
$200,001 to $500,000	170	62,273	1,193,924
$500,001 to $1,000,000	100	87,465	1,579,100
Over $1,000,000	109	497,325	11,591,814
Total	1,441	$727,007	$15,585,845

The following table gives by states the number of state banks and trust companies which were members of the federal reserve system on February 28, 1928:

[23] 11 Fed. Res. Board, 1924, p. 136.

[24] This included three banks with a capital of less than $25,000 as follows: Mississippi, 1 with capital of $15,000; Tennessee, 1 with $15,000 capital; Texas, 1 with capital of $17,500. These were the only banks of less than $25,000 capital that were at that time members under the eligibility amendments of 1923.

	Number of Member State Banks and Trust Companies	(In Thousands of Dollars) Loans and Discounts	Total Resources	Total Number of State Banks and Trust Companies in the state
Michigan	152	$ 615,022	$1,035,645	614
New York	108	3,560,262	6,405,110	585
Pennsylvania	98	546,519	1,146,673	756
Texas	93	32,180	52,597	740
Illinois	81	816,568	1,387,587	1,340
Ohio	79	928,083	1,432,778	719
New Jersey	67	419,257	719,305	269
Iowa	60	69,137	108,664	1,065
Missouri	60	224,748	479,673	1,254
Georgia	49	35,620	58,838	372
Washington	44	30,804	58,397	246
Oregon	29	17,866	36,285	152
Massachusetts	25	398,850	617,646	292
Montana	24	17,955	40,852	133
Utah	24	29,289	46,030	84
Arkansas	23	37,982	58,858	359
Wisconsin	19	66,205	113,520	816
Indiana	17	39,896	76,154	820
West Virginia	17	27,371	42,478	212
California	16	505,162	840,948	276
Idaho	15	5,518	11,624	91
Alabama	15	23,201	32,990	249
Minnesota	15	8,058	13,627	869
Virginia	12	53,135	78,419	329
South Carolina	12	8,574	15,423	199
Louisiana	10	132,912	226,314	196
North Carolina	9	55,494	89,692	374
South Dakota	9	3,571	6,510	316
Tennessee	8	55,016	88,387	404
Kentucky	7	49,334	78,782	461
Florida	7	15,064	27,582	255
Kansas	6	3,070	6,390	878
Nebraska	5	1,639	2,268	777
Maryland	5	48,497	90,357	159
Delaware	4	31,469	49,158	30
Rhode Island	4	153,543	317,547	24
Connecticut	4	36,354	51,870	168
Colorado	4	9,737	22,166	165
Maine	3	14,143	27,735	85
Mississippi	3	2,223	3,481	289
Oklahoma	3	692	1,302	333
Wyoming	3	1,609	2,851	59
Arizona	3	9,304	18,372	31
New Mexico	2	332	900	30
New Hampshire	1	832	1,297	68
North Dakota	1	71	98	371
Vermont	0	......	....	59
District of Columbia	0	......	....	29
Nevada	0	......	....	25
Total	1,255	$9,142,168	$16,023,180	18,427

In order of resources of state bank and trust company members the highest ranking states were as follows, on February 28, 1928:

State	Member State Banks and Trust Companies	Resources (In Thousands of Dollars)
New York	108	6,405,110
Ohio	79	1,432,778
Illinois	81	1,387,587
Pennsylvania	98	1,146,673
Michigan	152	1,035,645
California	16	840,948
New Jersey	67	719,305
Massachusetts	25	617,646
Missouri	60	479,673
Rhode Island	4	317,547
Louisiana	10	226,314
Wisconsin	19	113,520
Iowa	60	108,664
Maryland	5	90,357
North Carolina	9	89,692
Kentucky	7	78,782
Virginia	12	78,419

The states which on February 28, 1928, ranked the lowest in this respect were:

State	Member State Banks and Trust Companies	Resources (In Thousands of Dollars)
Nevada	0	0
Vermont	0	0
North Dakota	1	98
New Mexico	1	900
New Hampshire	1	1,297
Oklahoma	3	1,302
Nebraska	5	2,268
Wyoming	3	2,851
Mississippi	3	3,481
Kansas	6	6,390
South Dakota	9	6,510
Idaho	15	11,624
Minnesota	15	13,627
South Carolina	12	15,423
Arizona	3	18,372
Colorado	4	22,166
Florida	7	27,582
Maine	3	27,735
Alabama	15	32,990
Oregon	29	36,285

New York, Ohio, and Illinois furnish over 50 per cent of the non-national banking resources of the federal reserve system. Add Pennsylvania, Michigan, California, and New Jersey and you have over three-fourths of all the member state banking resources. The number of member state banks in a state is no criterion of the importance of that state to the federal reserve system. For example, four Rhode Island banks bring into the system $317,547,000 in resources. But ninety-three Texas member non-nationals can combine resources of only $52,597,000.

Considerable variation exists between districts as to the proportion of eligible state member banks enrolled. Of the 9,000 state banks which are eligible under the original requirements of the Federal Reserve Act, the proportions enrolled in the various districts are, approximately: New York, 46 per cent; San Francisco, 28 per cent; Dallas, 26 per cent; Philadelphia, 22 per cent; Boston, 21 per cent; Cleveland, 16 per cent; Atlanta, 15 per cent; Chicago, 13 per cent; St. Louis, 11 per cent; Minneapolis, 11 per cent; Richmond, 7 per cent; and Kansas City, 3 per cent.

Those districts which have enrolled the smallest proportion of the eligible banks are, in general, those districts where small banks abound in large numbers. The majority of these banks deal mostly in agricultural rather than commercial loans. Small banks of this kind have never been favorable to membership in the federal reserve system, claiming that it has little to offer them. The esteem with which bankers regard the federal reserve system varies from district to district. The campaign to increase membership was more vigorous in some districts than in others. Differences in state laws render the advantages of membership unequal from state to state. Large city banks have in some cases encouraged their country correspondents to remain out. It is reasons of this type which may be offered to explain the differences in membership in the various districts.

NOTE:—The controversy over the attitude of the federal reserve system towards branch banking is discussed in chapter XV on "State Banks and Branch Banking in the Federal Reserve System."

Certain rulings by the Federal Reserve Board on questions relating to state bank and trust company members since 1922 will be summarized below.

a. After the amendment of March 4, 1923 some non-national members considered reducing their capital below $25,000 in order to retain membership with a smaller capital, intending to increase it again later. The Board decided that this was not permissable under the law and would subject the bank to expulsion from the system.
(*Fed. Res. Bull.,* Nov., 1923, p. 1195).

b. A State member bank filed notice of withdrawal. Subsequently it increased its capital stock. The question was, must this bank increase its subscription to federal reserve bank stock by six per cent of the increase, even though it is to withdraw at the end of the six months period? The Board ruled that it must do so, since it was still a member and must fulfil all the requirements of the law until it withdrew. (*Fed. Res. Bull.,* April, 1924, p. 278).

c. The question arose whether federal reserve banks might conduct examinations of state member banks with examiners other than those selected or approved by the Federal Reserve Board. The act as originally enacted did not specifically require such approval. But the Board ruled that the amendment of June 21, 1917, while not specifically superseding the clauses of the original act dealing with this question, made such approval imperative.
(*Fed. Res. Bull.,* April, 1924, p. 278).

d. A state member bank wished to open a trust department. The Board ruled that before it did so it must secure the Board's permission, since it constituted a material broadening of the functions of the bank. Regulation H, Section IV, series of 1924 says that except with the permission of the Board no state bank or trust company member can cause or permit any change to be made in the general character of its assets or functions as exercised at the time of its admission as would tend to affect materially the standard maintained at the time of its admission to the system. Agreement to this provision was required as a condition of membership. Opening of a trust department was a change of a nature requiring the approval of the Board.
(*Fed. Res. Bull.,* Nov., 1924, p. 865).

e. The question arose whether under the Clayton anti-trust law a person who is a director of several banks, one being a state institution which consolidates with another under state law, must apply to the Board to continue to serve the consolidated institution with the other banks he has been serving.

The Board ruled that this was not necessary unless the result was to affect competition between the banks he was serving as director in such a way as to make revocation of the permit necessary. The federal reserve agent was requested to investigate and advise the Board.

This ruling, said the Board, coincided with the ruling of November 6, 1923, on the consolidation of National banks. It was stated

there that consolidation vests in the consolidated institution all the rights, franchises, or interests of the consolidating bank including the right to directors' services.

There is no objection if the state statute in this case gives the new bank all the rights, franchises, and interests of the consolidating banks.

(*Fed. Res. Bull.,* Jan., 1925, p. 28–29).

f. A state member bank gave notice of withdrawal but did not retire at the expiration of the six months period. Was a new notice of withdrawal necessary? The Board ruled that if eight months passed after the notice was necessary, another six months must then expire before the bank could withdraw. Exceptions might be made in special cases. (*Fed. Res. Bull.*, Dec., 1925, p. 882).

g. Other rulings during the period covered by this chapter will be treated in subsequent chapters in appropriate places.

CHAPTER XI

ADVANTAGES OF MEMBERSHIP FOR STATE BANKS

The benefits which have resulted from the establishment of the federal reserve system are now so well known that no lengthy discussion is here necessary. Not only has it created a wider discount market, made possible the development of the bank acceptance, introduced a higher degree of elasticity in the currency, centralized a large share of the reserves of the country, established improved methods of government financing, rendered more efficient the system of transferring funds, and provided a country-wide check clearing and collection system, but it has introduced into the banking situation a degree of stability never before known and has removed the fear of such disastrous financial panics as have been experienced so many times in the past.

It may be asked, however, what are the special benefits which accrue to those banks which have joined or expect to enter the system in the future?

I

The advantage which is generally given first place is the privilege of rediscounting commercial paper at the federal reserve banks. All the testimony of hundreds of members that has at various times been gathered reveals this fact beyond a doubt. At last, the banking institutions of the country have a place where, in time of need, they can take commercial paper and secure actual cash if they desire.

Many banks which thought that they did not have any paper which was eligible under the terms of the federal reserve act have found that they either do possess such paper or can acquire it with little difficulty. A shift in

the type of trust company investments has been noticed in certain districts. Mr. E. P. Passmore, formerly Governor of the Philadelphia Federal Reserve Bank, and later President of the Bank of North America, commented on this change as follows:

"Unlike Boston, New York, Chicago, and St. Louis, where trust companies engage in commercial business, in Philadelphia virtually all the available resources of our trust companies have been used for loans based on investment securities. Thus the tremendous lending power of trust companies has not been available for the requirements of our rapidly expanding industries, but has been invested for the most part in collateral loans, long time bonds and mortgages. However, the recent entry of many of the larger and more active trust companies into the Federal Reserve System has brought about some change in policy, with the result that they now invest in commercial paper and other short-time securities of a liquid character."

The eligible paper which a federal reserve bank may rediscount for a member bank consists of notes, drafts, and bills of exchange, the proceeds of which have been used or are to be used in producing, purchasing, marketing, or carrying goods, merchandise, or agricultural products including live stock. It may also be paper used for carrying or trading in United States notes or bonds. It cannot be paper the proceeds of which are to be used in making permanent improvements or for carrying or trading in stocks and bonds other than those of the government. Commercial paper cannot have a maturity of more than 90 days to be eligible for rediscount, and agricultural or livestock paper cannot have a maturity or more than nine months at the time of rediscount.

If a bank wishes to build up its reserve balance at the federal reserve bank all that it needs to do is to send the necessary paper to be rediscounted. Or it may borrow on its own note to obtain the required balance. If for some reason it needs actual cash it can follow the same procedure. Because of this many member institutions have been able to reduce their cash on hand to just enough to take care

of their daily needs. If they require an additional amount of cash all that is necessary is a telephone call or telegram to the federal reserve bank or its branch and in practically no section of the country does it take longer than twenty hours to lay down the money at the door of the member bank. The commercial paper or the collateral need not, in emergency cases, be received by the reserve bank before aid is dispatched to the member bank. The claim that such operations involve an aggravating amount of red tape has been in general shown to be untrue. In some sections the danger of loss from hold-ups and robberies has been greatly lessened because of the decrease in the amount of cash which the member bank or trust company must carry on hand. The surplus cash released when the bank enters the system can be used to originate the reserve balance at the federal reserve bank or may be invested at a profit.

Governor George J. Seay, of the Federal Reserve Bank of Richmond, worked out figures showing how great a reduction in the amount of cash on hand has been made possible for national banks by the federal reserve system. He shows that comparing the period from 1909 to 1913 with the years 1922 and 1923, national banks carried the following working reserves against deposits, expressed in percentages:

	1909–1913	1922–1923
Central reserve city national banks	30%	16.9%
Other reserve city national banks	35.9%	23.7%
Country national banks	26.5%	17.6%
Average for all types	30.1%	19.2%

The average amount of cash in vault carried by all types of national banks declined during the same period from 12.2 per cent to 2.1 per cent of all deposits.

Carrying the comparison further Governor Seay shows that if the computation is made on the basis of what would have been required had the same reserve requirements remained in effect in 1922 and 1923 as in the period 1909

to 1913, the federal reserve system has made possible reductions in reserves of 44, 34, and 34 per cent respectively for the three types of national banks.[1]

An exact comparison for reduction in reserves for non-national members is not possible without examination of individual bank reports for these banks before they entered the system. But a comparison may be made between the reserves of all state banks and trust companies before 1914 with the reserves held by member state institution during the past few years. The following table shows how great a reduction in actual reserves has been effected:[2]

	All State Banks and Trust Companies (Savings Banks Excluded)	All Member State Banks and Trust Companies
	Five year average 1910–1914 (Amounts in Thousands of Dollars)	Five year average 1921–1925 (Amounts in Thousands of Dollars)
Individual deposits	6,457,598	9,400,455
Due to banks, bankers, etc.	437,132	940,829
U. S. deposits	....	113,279
Cashiers checks, Certified checks, etc.	....	389,230
Total Deposits	6,894,730	10,843,793
	(% figure is %	of all deposits)
Cash	520,859	171,771
	7.5%	1.58%
Due from banks	1,099,164	471,923
	15.9%	4.35%
Reserve with Federal Reserve Bank	....	749,400
	....	6.9%
Items in process of collection with Federal Reserve banks	....	200,849
	....	1.85%
Total reserve against deposits	23.4%	14.68%

[1] Seay, George J., *The Position of Country Banks Under the Federal Reserve System.* Printed by Federal Reserve Bank of Richmond, 1923.

[2] Compiled from the annual reports of the Comptroller of the Currency.

Another estimate of the amount to which reserves have been re-

These figures prove that membership in the federal reserve system has been responsible for a tremendous reduction in reserves for non-national member banks as well as for national banks. Average reserves have declined from 23.4 to 14.68 per cent. Had the federal reserve system not been created and were the previous reserve requirements in effect now, the state banks and trust companies would be holding as cash in vault $813,284,000 instead of only $171,771,000. They would also have probably been carrying with other banks, accounts with correspondents, $1,724,163,000, instead of $471,923,000. The actual amount of funds released, estimating on what would have been required as an average from 1921 to 1925 had there been no change, is $641,513,000 in cash and $302,000,000 in bankers balances. Were this sum lent at an average rate of 6 per cent it would bring in additional earnings of approximately $55,000,000 which the federal reserve system made possible.

As an offset against this, however, must be charged the loss through non-payment of interest on the reserves carried with the federal reserve banks. Such reserves would formerly have earned from two to two and one-half per cent interest from a correspondent bank. This would run between 15 and 20 million dollars. Additional loss is alleged to arise from the fact that the items in process of collection can no longer count as reserve for members as they once did and still do under state laws. Even at that, however, correspondents as a rule pay no interest on un-

duced was made by the Federal Reserve Bank of Chicago. The results are substantially the same as those reached by the present writer. The comparison made by the Chicago Bank was, however, between only two dates, June 30, 1914, and June 30, 1925. It found that during that period the working reserves of national banks were reduced from 28.1 per cent in 1914 to 18.3 per cent in 1925; working reserves of state member banks were reduced from 21.5 per cent in 1914 to 14.0 per cent in 1925; and working reserves of nonmember banks were reduced from 21.5 per cent to 16.7 per cent. Cash in vault declined from 11.9 per cent of deposits to 1.8 per cent for national banks, from 6.7 per cent to 1.3 per cent for member state banks, and from 6.7 per cent to 3.1 per cent for nonmembers. See pamphlet Benefits to Bankers from Membership in the Federal Reserve System, Federal Reserve Bank of Chicago, Nov. 1926.

collected balances. They do give immediate credit in many cases, but do not begin paying interest until the checks are actually collected.

The net result seems to be that membership has made possible, by conservative estimate, increased earnings of from 25 to 30 millions a year for non-national member banks. This, of course, is for the member state banks and trust companies as a whole. For a small number of individual banks the possibility of increased earnings may be negligible.[3]

The reason why membership may not be more profitable than non-membership at present is that nonmembers have followed the practice of the members in cutting down their cash in vault and balances with bankers. This has been due to the establishment of the federal reserve system because the advantages of membership have been passed on by city member banks to their country correspondents. The city banks have enjoyed the same relationship with their city correspondents as have the federal reserve banks with their members. The city bank usually is a member of the system, 90 per cent of all bankers balances are held by member banks. The nonmembers enjoying indirectly through their city correspondents the facilities of the reserve system have followed the example of the member institutions and cut down their reserves.

All state banks and trust companies in the period from

[3] It was asserted recently by Clyde O. Fisher that since the increase in loans made possible by decreased reserves would increase prices the banks were ultimately no better off with regard to the purchasing power their increased earnings brought them. He admitted, however, that where banks did not all decrease reserves and increase loans to the same extent that those whose loans and additional investments increased the most would be proportionately better off than the others. Right here is where the advantages of membership would show themselves. For the members having decreased reserves more than nonmembers receive a proportionately greater increase in earnings to meet the higher price level than do nonmembers. To this extent, therefore, the claim that membership will bring increased earnings to offset the loss of interest on reserves deposited with the federal reserve bank is justified. See Clyde O. Fisher, A Banking Fallacy, *American Economic Review*, December, 1926, pp. 663–665.

1910 to 1914 held cash in vault to an amount of 7.5 per cent of deposits, and bankers balances of a percentage of 15.9. But during the three year period 1923 to 1925 cash in vault fell to 2.3 per cent and bankers balances to 13.8 per cent of deposits. These figures, however, include the state banks and trust companies which are members.

When the statistics of nonmembers are separated from those of members it is found that nonmember cash reserves have dropped to approximately 3.3 per cent. Bankers' balances of nonmembers have been cut down only slightly, however, being now one to two per cent less of deposits than formerly. Total reserves for this group of banks average now about 17 per cent where formerly they were 23 per cent of deposits.

This decrease in reserves has released sufficient funds for investment or lending at 6 per cent to net the nonmember state banks and trust companies (excluding all savings and private banks) something like $20,000,000 additional to their previous earnings. This fact does much to offset the advantage of membership for many state institutions, as the system has made banking much more profitable for nonmembers than formerly. The comparison that must be made is between present earnings as members and earnings as nonmembers. Reduction of reserves by nonmembers has destroyed much of the specific advantage of membership in this respect.

While too free use of the rediscounting privilege is not to be encouraged because of the possible dangers of inflation, a sound discount policy can minimize this evil greatly. For a considerable period since the establishment of the federal reserve system, the discount rates at the federal reserve banks have been so low that it has been possible to rediscount at a considerable profit.

The advantages from rediscounting have, indirectly, been passed on to the nonmember institutions by their member bank correspondents. From July, 1921, until June

26, 1923, the Federal Reserve Board permitted the member institutions to act as agents for the nonmembers in the rediscounting of paper at the reserve banks. It will be generally admitted that while this may have been necessary as an emergency measure yet it removed a very strong incentive for entering the system, and gave the nonmembers many of the advantages of membership without partaking of the burdens. But even before and after this permissive period members were receiving funds for their nonmember correspondents. It is to be hoped that some way may be devised to prevent the member institutions from so freely passing on the advantages of the system to their nonmember correspondents.

The question may now be asked as to how freely the member institutions have availed themselves of the rediscounting privilege. This question may be answered by studying the following table.[4]

Year	Number of member banks on Dec. 31	Number rediscounting	Percentage rediscounting during year
1919	9,066	5,993	66
1920	9,629	6,941	72
1921	9,841	7,415	75
1922	9,916	6,956	70
1923	9,896	6,333	64
1924	9,682	6,060	62
1925	9,489	5,183	54
1926	9,260	5,343	57

It may be asked, what proportion of member state institutions rediscounted? No figures are available on this point, but the amounts are as follows:

[4] 7 Fed. Res. Board, 1920, p. 183; 9 *Ibid.*, 1922, p. 121; 12 *Ibid.*, 1925, p. 80, 13 *Ibid.*, 1926, p. 90.

Year	Total rediscounts (Amounts in millions of dollars)	For non-national banks (Amounts in millions of dollars)	Percentage rediscounted by non-national banks
1919	79,173	15,655	19.8
1920	85,320	16,033	18.8
1921	57,759	15,030	26.0
1922	22,082	5,460	24.7
1923	38,380	9,693	25.2
1924	15,419	4,092	26.5
1925	32,563	11,251	34.2
1926	37,682	13,923	36.9

The figures show that while in proportion to their numbers the non-national banks have done more than their relative share of rediscounting, yet 1925 is the only year in which they have done their proportionate share if comparison is based on relative amounts of capital, surplus, and resources.

That member banks may rediscount paper at the federal reserve banks at a rate which is much lower than that which they are charging their own customers on the same paper is evident from the following comparisons.[5]

AVERAGE RATES CHARGED BY ALL FEDERAL RESERVE BANKS ON DISCOUNTED BILLS

1918	4.28	1921	6.01	1924	4.20
1919	4.26	1922	4.52	1925	3.70
1920	6.02	1923	4.47	1926	3.96

By districts, average rates charged in 1923, 1924, 1925, and 1926, by the federal reserve banks on rediscounted bills were:

	1923	1924	1925	1926
Boston	4.42	4.10	3.59	4.00
New York	4.42	3.92	3.43	3.84
Philadelphia	4.50	4.07	3.58	4.00
Cleveland	4.50	4.11	3.59	4.00
Richmond	4.50	4.28	4.00	4.00
Atlanta	4.50	4.32	4.00	4.00
Chicago	4.50	4.33	4.00	4.00
St. Louis	4.50	4.34	4.00	4.00
Minneapolis	4.50	4.45	4.00	4.00
Kansas City	4.50	4.40	4.00	4.00
Dallas	4.50	4.34	4.00	4.00
San Francisco	4.44	4.30	3.57	4.00

[5] 12 Fed. Res. Board, 1925, pp. 39 and 86.

Compare these with the average rates charged by members in all districts to their customers on this same paper:

BANKS IN TOWNS AND CITIES OF—

	Population under 15,000 All Districts	Population 15,000 to 99,000 All Districts	Population 100,000 and Over All Districts
December 1921	8.0	7.2	6.1
December 1922	7.7	6.4	5.1
March 1923	7.7	6.4	5.1
June 1923	7.9	6.4	5.3
September 1923	7.5	6.4	5.4
December 1923	7.5	6.3	5.4
March 1924	7.5	6.4	5.5
June 1924	7.6	6.3	5.6
September 1924	7.3	6.4	5.6
December 1924	7.1	6.2	4.9
March 1925	7.1	6.1	5.1
June 1925	7.3	6.1	5.2
September 1925	7.0	6.0	5.1
December 1925	6.9	6.0	5.1
March 1926	7.2	6.1	5.1
June 1926	7.2	6.2	5.3
September 1926	7.1	6.2	5.2
December 1926	7.0	6.0	5.2

Member institutions may, in addition to rediscounting, borrow from the federal reserve banks on their own promissory notes for a period of not exceeding 15 days, if the note is secured by eligible paper or government obligations. Many banks and trust companies which have not been inclined to rediscount have used this method of obtaining funds or building up their reserves. Some bankers who claim that their customers refuse to let paper bearing their signatures or indorsements be rediscounted at the federal reserve bank, use this method of borrowing on government obligations. It has been frequently stated that the limitation of the period for which these notes may run to 15 days is objectionable, that although the notes may be continually renewed the bother of renewing so frequently is a nuisance.

The result of the privilege of rediscounting or borrowing is a feeling of security which comes from knowing that help may be obtained without delay whenever it is needed. Banker after banker has stated that there is a peace of mind arising from the fact that commercial paper may always be rediscounted or collateral loans obtained and the proceeds received in actual cash if necessary. Those bankers, of whom there are many, who experienced difficulty in 1907 stress this point above all others. The experience of those state institutions which have become members shows this to be one of the outstanding benefits of membership. In former crises when the country banks asked for aid from their city correspondents, the city bank was generally so busy trying to save itself that it could not give much assistance to its country correspondent. For member institutions such experiences in the future are made impossible, and many members who claim that the non-payment of interest on their reserve balances results in a net loss to them will hasten to add that they consider the sum lost may well be considered as a premium on insurance against future financial difficulty, and cheap insurance at that. The member institutions may now feel confident that they will be taken care of in emergencies and that they have placed their depositors in a much safer position than before. As Mr. Joseph S. Calfee, a former President of the National Bank Section of the American Bankers' Association, once said, "Members enjoy a sense of satisfaction and security which did not exist prior to the enactment of this law."

II

The prestige attached to membership has in many communities come to be a valuable asset. Many people believe that when the sign "Member of the Federal Reserve System" appears upon the window of a local bank the institution has placed itself in a safer position, where it will

be able to protect its depositors at all times. For years many persons have believed that national banks were safer than those chartered by the states. That feeling has broadened somewhat to include all member institutions, although confidence has been lessened somewhat by the failures of member institutions since 1919. It is still true that members as a whole show a smaller proportion of failures than nonmembers. Many state banks have joined the system because they believed they could compete on more equal terms with the national banks by so doing. Numerous banks have testified that they have advertised their membership extensively and have found that it increased their business. Some of the federal reserve agents have advised the state institutions to secure new depositors by this method. The obvious result was that many members advertised their membership too extravagantly and in terms which were exaggerated.

Apparently the Federal Reserve Board made little effort at first to control the way in which the members were advertising the fact that they had joined the system. It was soon evident however that some of the banks were going too far. The Federal Reserve Board ruled that while the members could advertise that they were "Under Government Supervision" it was carrying matters too far to state that they were "Under Government Protection." Later, however, even this concession was withdrawn, for the Board now holds that it is improper to advertise that members are under government or national supervision or that membership is a guaranty of safety.[6] It is contended that many of the advertisements which state institutions have used have been misleading to the public, leading many people to believe that membership in the federal reserve system was an almost perfect guaranty against failure. Any one who held this view should now be disillusioned for over 200 state member institutions and 700 national banks

[6] *Fed. Res. Bull.*, March, 1923, pp. 300–302.

have been closed since 1919. Even at that, however, the member banks have maintained a slightly better record for failures than the nonmembers. Take the years 1924, 1925, 1926, and 1927, for example. In those four years over 3,000 banks of all kinds failed in this country. A sorry record! These banks carried down in deposits over $850,000,000.

Comparisons show that approximately 5.5 per cent of all nonmember banks, approximately 4.3 per cent of the state banks and trust company members, but only 3 per cent of all national banks failed during 1924 and 1925.[7]

A similar comparison with regard to deposits shows that the closed banks contained 1.3 per cent of all deposits held by nonmembers, .62 per cent of all deposits held by national banks, but only .2 per cent of all the deposits held by member state bank and trust companies. These comparisons certainly greatly favor the member banks from the standpoint of safety.

The Board now takes the position that the state institutions should not make any statement in their advertising beyond the fact that they are members of the system and have access to the facilities and resources of the federal reserve banks. Member state institutions are not really under government supervision, it claims, for they are examined by the federal reserve bank and not by government officials. The federal reserve banks are private and not public or government corporations. While, technically, members are subject to examination by the Federal Reserve Board, yet this does not result in national supervision for the examinations are really made by the federal reserve banks. Finally, concluded the ruling of the Board, the fact that state examinations are accepted as being sufficient in so many cases further refutes the claim that the member state banks and trust companies are under national or government supervision.

[7] 12 Fed. Res. Board, 1925, pp. 184–185.

III

The many services performed by the federal reserve banks free of charge are also attractions. The reserve bank pays the insurance, postage, and express on shipments of paper currency, silver, and other coin from it to the member bank or trust company. It also bears this expense on similar shipments from the member institution to the reserve bank. If requested by a member institution the reserve banks will generally ship currency to other member or nonmember institutions in the same district. The expense of this is borne by the reserve bank only when the shipment goes to a member. The reserve banks also pay the telephone and telegraph charges in connection with money shipments and deposit transactions for member banks and trust companies. One excellent feature of this arrangement is that the federal reserve banks keep the members supplied with sufficient amounts of clean, new paper currency. The Federal Reserve Board gave the following reasons for adopting the policy of paying these charges:[8]

> "There are, unavoidably, some advantages enjoyed by member banks located in Federal Reserve or branch bank cities which are not shared by banks in other towns and cities, but the Board is endeavoring, as far as possible, to give equal facilities to all member banks, and has therefore, authorized the Federal Reserve Banks to pay all charges on shipments of currency to or from member banks. A member bank, therefore, located at a distance from its Federal Reserve Bank is thus put in as favorable a position with respect to currency transfers as a member bank located in the Federal Reserve City, with the exception of the time involved in transit."

Some federal reserve banks have paid the cost of returning to member institutions the collateral lodged as security for advances made by the reserve banks.[9] Most of the reserve banks will transfer for a member bank or

[8] 5 Fed. Res. Board, 1918, p. 74. [9] 6 Fed. Res. Board, 1919, p. 35.

trust company, free of charge, funds to any other member institution anywhere in the United States. A member of the system may draw an exchange draft on its federal reserve bank, such drafts being available for immediate credit at any reserve bank or branch of a reserve bank.

The federal reserve bank will receive from the members for safekeeping, without charge, securities of the United States Government owned by them.

IV

Another valuable service is the advice which officers of member institutions may obtain from officers of the reserve bank on a number of matters. This has been valuable to many members and has helped to develop higher standards of banking in a number of districts. The federal reserve banks have gone to great expense in sending representatives to member institutions informing them as to how they may use the facilities of the system to better advantage in their daily relations with their customers. Many bankers have testified that this service has been of great value to them. Some state banks upon announcing that they wished to withdraw have been visited by officers or representatives of the reserve banks who showed them how to make fuller use of the advantages of the system with the result that the dissatisfied banks decided to retain membership.[10] In some cases, representatives of the reserve banks have spent a great deal of time at the member institutions rendering assistance. During the influenza epidemic of 1918 some of the member banks and trust companies were practically operated for a while by representatives of the reserve banks, because of the illness of the officers of the members.

V

To many members of the system the federal reserve clearing and collection system has been a benefit and not

[10] *Ibid.*, p. 372.

an objection to membership. Those banks which received a large amount of checks on banks in other sections of the country have found that they can collect these checks in less time, and with less trouble and expense than formerly. The federal reserve banks now collect without charge, a tremendous number of checks annually.

The total number of items and amounts of cash items, exclusive of duplications, handled during the last eight years are:

Year	Number of Items	Amounts
1919	305,159,000	$136,493,000,000
1920	452,116,000	156,509,000,000
1921	522,665,000	118,844,000,000
1922	584,873,000	150,164,000,000
1923	639,214,000	196,636,000,000
1924	684,002,000	209,124,951,000
1925	716,534,000	247,184,505,000
1926	758,499,000	261,402,000,000

So it may be readily seen that this feature of the system has grown to enormous proportions. It is generally in the larger cities that the clearing and collection system is most popular, because many of the banks in these cities have remitted at par for years, but were not able to collect a large number of checks received by them without paying a so-called exchange charge. The country banks have in general looked with disfavor upon the system because of the loss in profits which remission at par involved. Today checks on approximately 22,000 banking institutions in the United States may be collected at par under this system. To member institutions it has been advantageous to be able to collect checks on 13,000 nonmember banks and trust companies without deductions for exchange. Over 85 per cent of the banks in the United States now remit at par. By direct routing of checks considerable time is saved, and the funds become available more quickly than under the old system of indirect routing which had grown up in an endeavor to avoid sending checks to banks which deducted

for exchange. The "deferred availability" plan, although arousing opposition, has abolished to a large degree the iniquitous custom of permitting checks in transit to count as reserves. A large part of the "float" has disappeared.

The federal reserve banks will collect, without charge, for all institutions on the par list not only checks but notes, drafts, acceptances, certificates of deposits, bonds, and coupons.

While a nonmember may secure many of the advantages of the collection system yet to get the fullest benefit a bank must be a member.

VI

Those banks which have developed the use of the acceptance have another advantage in that their acceptances enjoy a more favorable rate on the market than those of nonmembers. It will be remembered that the first trust companies to join the system testified that this lower rate had resulted in a considerable profit to them. The following table shows the acceptance liabilities of all member institutions on the date given: [11]

(Amounts in millions of dollars)

Date	National Banks	State Institutions	Total
June 30, 1919	272	194	466
Dec. 31, 1919	407	233	640
June 30, 1920	431	242	673
Nov. 15, 1920	406	241	647
June 30, 1921	250	180	430
Dec. 31, 1921	218	148	366
June 30, 1922	189	131	320
Dec. 29, 1922	223	177	400
Dec. 31, 1923	222	204	426
Dec. 31, 1924	262	236	498

Bank acceptances held by the federal reserve banks,

[11] Compiled from the *Fed. Res. Bull.*

distributed by the type of accepting institutions are as follows: [12]

(Amounts in millions of dollars)

Date	Total	Member bank	Nonmember institution	Private banks	Foreign banks
Dec. 31, 1916....	121	67	36	18	
Dec. 31, 1917....	267	228	11	20	8
Dec. 31, 1918....	285	238	13	20	13
Dec. 31, 1919....	566	405	65	56	40
Dec. 31, 1920....	259	169	38	25	26
Dec. 31, 1921....	145	110 (nat'l, 60; state, 50)	14	12	9
Dec. 30, 1922....	271	189 (nat'l, 97; state, 92)	38	27	17
Dec. 31, 1923....	352	239(nat'l,119; state, 120)	56	31	26
Dec. 31, 1924....	387	258(nat'l,134; state, 124)	61	40	28

These figures reveal that approximately one third of the acceptances held by the reserve banks are furnished by member state institutions. So there is undoubtedly profit from this course to be derived from membership owing to the fact that member acceptances bear a slightly more favorable rate than those of nonmembers.

Not all states, however, permit state banks to accept bills of exchange. In 1922 the following ten states had not definitely given such powers: [13]

Arizona, Delaware, Florida, Idaho, Illinois, Kentucky, North Dakota, South Carolina, South Dakota, and Wyoming. Kansas forbids acceptances. Twenty-six states definitely authorize acceptances. Nebraska, Nevada, New Hampshire, New Mexico, Vermont, and Wisconsin have permitted their banks to accept indirectly by stating in the statutes permitting them to join the federal reserve system that they shall have the privileges of member banks in those states. The banking commissioners of Colorado and

[12] *Ibid.;* Also from Annual Reports of the Fed. Res. Board for 1920, 1921, and 1922, pp. 164, 169, and 86, and 1924, p. 62.

[13] Cousins, W. S., *Acceptance Bulletin,* Feb., 1922, p. 18.

Utah have granted permission to individual banks to accept. In Minnesota and Washington accepting is possible because of a statute which says that savings banks may purchase bank acceptances when the accepting bank is a bank or trust company incorporated by those states.

Not many of the present nonmembers would find membership advantageous in this respect since very few of them accept bills of exchange in any quantity.

VII

No member institution may carry a deposit of more than 10 per cent of its capital and surplus with any nonmember bank or trust company. Therefore, banks and trust companies which desire to act as correspondents for other institutions find it an advantage in some cases to belong to the system. The Federal Reserve Board in 1923 gave to this clause of the Act a stricter interpretation in declaring that items sent by a member to a nonmember for collection must be considered as on deposit and so must come under this prohibition. While lawyers, as usual, differ as to the correctness of this interpretation, the Board has decided that the spirit of the Federal Reserve Act requires the stricter ruling to avoid any possible danger arising from the placing of funds of member institutions in banks and trust companies not under the control of the federal reserve banks.[14]

VIII

Those banks desiring to be made depositories for postal savings must join the system to obtain these deposits if there is another member bank or trust company in the locality. If more than one in the community are members they will receive these deposits in proportion to their capital and surplus. Member State institutions may now be appointed government depositories.

[14] *Fed. Res. Bull.*, April, 1923, pp. 428–429.

SUMMARY

The advantages which a state bank or trust company would gain by joining the federal reserve system may be outlined as follows:

1. (*a*) Rediscounting, to secure aid in time of emergency and remedy a temporary shortage of currency, also to build up reserve.
   (*b*) Ability to borrow on member banks own 15 day promissory note, secured by commercial paper or government obligations.
   (*c*) Feeling of security and peace of mind arising from knowledge that assistance may always be secured.
2. Prestige which attaches to membership and its value as an advertising feature to attract new business.
3. Services performed free of charge by the federal reserve bank. These are payment of all expenses of transferring funds or currency by mail, express, or wire.
4. Assistance received from officers of the federal reserve banks on many matters.
5. Full benefit from check clearing and collection system.
6. Profit from more favorable rate on member bank acceptances.
7. Possibility of receiving larger deposits from other member banks and trust companies.
8. Can serve as depositories for postal savings funds, or as government depositories.

CHAPTER XII

VALIDITY OF OBJECTIONS TO MEMBERSHIP

Over 9,000 eligible state banks and trust companies with a capital of $25,000 or more still remain outside of the federal reserve system. Of 1,000 such banks in the Kansas City district less than thirty are now members. Of 2,400 such banks in the Chicago district only 300 now hold membership. In the St. Louis district only 100 out of 1,000 eligibles of this class are enrolled. The reasons why these banks still remain aloof will now be considered. The validity of the objections which they raise to membership will at the same time be tested.

I

Many state institutions see no advantage in allying themselves with the system because they already receive indirectly practically all of the advantages which membership would bring them.

The majority of the large city banks and trust companies are members and freely act as intermediaries in giving to their country correspondents who are not members indirect access to the federal reserve banks. As to the truth of this statement there is no room for doubt. It has been commented upon frequently by the various federal reserve agents.[1]

Mr. Gray Silver, of the American Farm Bureau Federation, stated in the hearings before the Joint Congressional Commission of Agricultural Inquiry that he knew of a number of cases where country banks had been urged by their

[1] Annual Reports of Fed. Res. Board for 1917 and 1919, pp. 405 and 306.

city correspondents not to join. He gave as the reason for this advice that the city banks did not wish to lose the business or accounts of the country banks and they feared that entry into the system would bring this about.[2] Reference to this attitude of the city banks was made in the preliminary statement of the Joint Congressional Committee of Inquiry into Federal Reserve Membership. This committee stated: [3]

"It has been brought to the attention of the members of the Committee that many city banks carrying reserve deposits of nonmembers are responsible to a large degree for the nonmembership in the Federal Reserve System of these nonmember institutions, they holding out assurances to the nonmember banks that every service and facility that would be offered to them by membership in the System is accorded to them, thus preserving to these big city correspondent banks the reserve balances and business which otherwise might flow freely to the Federal Reserve System. It has been pointed out to members of the Committee that such practices defeat the real purposes and intent of the framers of the Federal Reserve Act."

In his testimony before this Committee Governor Crissinger of the Federal Reserve Board described the present situation vividly.[4] The worst enemies of the system, he said, were the banks in it. These large city banks, he said told their country correspondents to stay out. It means that the reserve banks have to bid against the city banks for accounts, a strange rivalry. The city bank, said the governor, has the advantage. It pays interest on deposits, gives immediate credit for checks received, lends on paper which is illegal for reserve banks to take, and performs many services, some of them of a personal nature. The city bankers tell the nonmembers that they will do

[2] Hearings before Joint Commission of Agricultural Inquiry, part 6, p. 54.

[3] Statement of Joint Commission of Agricultural Inquiry on Membership in the Federal Reserve System, June 8, 1923, p. 2.

[4] *United States Investor*, Oct. 6, 1923, Vol. 34, p. 2306 and Oct. 20, 1923, p. 2483.

everything for them that a federal reserve bank can do. This situation, said Governor Crissinger, will keep membership from increasing, and the worst of it is that Congress is powerless when it comes to helping the reserve banks meet this kind of competition.

A recent investigation shows how extensive are the services which the city banks perform for their country correspondents.[5] The city banks will accept items drawn on any bank anywhere. They give advice as to the purchase and sale of commercial paper and securities. They will keep such papers and securities in safe deposit vaults without charge. They furnish credit information, offer facilities for foreign drafts, and perform fiduciary functions.

The federal reserve banks generally require members to list checks in separate cash letters according to availability. If they are unassorted the reserve bank applies the credit availability of the cash item in the letter taking the longest time to collect to all the others. But the city correspondent takes the checks unassorted, gives immediate credit, and pays interest when the funds are collected. The city correspondents in many cases really act as rerouting agencies.

The reserve banks charge for "dunning" drafts returned unpaid, but the city bank does not. If the country bank sells exchange on New York by drawing on its New York correspondent the check is not charged until it goes through the New York Clearing House, thus saving several days interest for the country bank. But if the transaction is performed through the federal reserve bank the charge is made more quickly.

Finally, city banks will accept telegraphic transfers from or to nonmembers, corporations, firms or individuals whereas the reserve banks require the transaction to be limited to member banks.

[5] Demmery, Joseph, "How the Federal Reserve System has Affected Correspondent Banks," *Journal A. B. A.*, Sept. 8, 1924, pp. 171–173.

The actual extent to which reliance is placed on their city correspondents by certain members of the federal reserve system is shown by the following table.[6]

	All banks	22 banks in federal reserve cities	248 banks not in federal reserve cities
Per cent of cash letters sent through reserve banks	21	56	16
Per cent of cash letters sent through correspondents	79	44	84
Per cent of collection items sent through reserve banks	12	36	11
Per cent of collection items sent through correspondents	88	64	89
Per cent of drafts drawn on reserve banks	13	21	12
Per cent of drafts drawn on correspondents	87	79	88
Per cent of currency received from reserve banks	87	69	89
Per cent of currency received from correspondents	13	31	11
Per cent of loans made with reserve banks	75	86	72
Per cent of loans made with correspondents	25	14	28
Per cent of paper rediscounted with reserve banks	89	100	86
Per cent of paper rediscounted with correspondents	11	..	14
Per cent of transfers made through reserve banks	56	77	49
Per cent of transfers made through correspondents	44	23	51

A study of this table shows clearly in what transactions the city banks are used by their country correspondents in preference to the reserve banks.

It is sometimes said that the large city bank is to its country correspondents what the federal reserve bank is to its member banks. It has been estimated that 90 per cent

[6] *Ibid.*, This is the result of a questionnaire sent by Demmery to 500 banks, of whom 270 replied.

of all bankers balances are deposited in member banks.[7] Paper comes up to the city bank from its country correspondent that may not be eligible for rediscount at the reserve bank. On this paper loans are made to the country bank. If the city member finds itself short of funds after such a transaction, it may take eligible paper held by it to the reserve bank and replenish its reserve or secure cash. In this way the city bank is "bootlegging" credit received from the reserve banks to nonmembers. Such a situation is almost impossible for the federal reserve banks to remedy.

Some bankers state, however, that they are not so unwilling to lose the balances of the nonmember country correspondents as many persons believe. During the depression of 1920 and 1921 some of them said they would have been glad to diminish the amount of such balances for they had to pay from 2 to 3 per cent interest upon them at a time when there was a scarcity of good liquid investments into which the deposits could be put.

One of the chief ways in which the benefits of the federal reserve system have been received by nonmembers has been by the member correspondent acting as an intermediary for the nonmember in the rediscount of commercial paper. This was strictly forbidden by section 19 of the original Act, except on permission of the Federal Reserve Board. There was considerable discussion very early as to how this prohibition was to be enforced. On August 1, 1915, the Board made a ruling which stated that the burden of enforcing this rule must rest on the officers of the federal reserve banks, who were to decide whether the proceeds of rediscounting were to be used by the member for making a loan to nonmembers. If it could be ascertained that the proceeds were to be reloaned by members to nonmembers the application for rediscount should be refused unless special permission could be obtained from the Federal Re-

[7] *Fed. Res. Bulletin*, Nov., 1923, p. 1176.

serve Board. But, said the ruling, if the member institution had in good faith acquired from the nonmember eligible notes by discounting them, and these were held as a part of its assets, there could be no objection to the acceptance of these notes by the federal reserve banks for rediscount, provided the officers were satisfied that the transaction was bonafide and that the bank obtaining the rediscount had not extended accommodation to the nonmember with the view of rediscounting the notes so acquired with the federal reserve banks. In the last analysis, concluded this statement of the Board, what is done regarding this matter must depend largely upon the discretion of the officers of the reserve banks, who must decide what the facts are in each case.[8] In a few cases the Board permitted such rediscounting upon the request of a reserve bank.

The Federal Reserve Board stated its position again in 1918 in these words: [9]

> "A nonmember bank could not, of course, obtain indirect accommodation from the Federal Reserve Bank through the medium or agency of a member bank except with the permission of the Federal Reserve Board, but if a member bank had acquired eligible paper in due course by discount from a nonmember bank, the member bank should hardly be precluded from rediscounting this paper with the Federal Reserve Bank because it bears the indorsement of the nonmember bank."

During the war the Federal Reserve Board gave general permission to the member banks to act as agents for nonmembers in the rediscounting of notes of the nonmembers at the federal reserve banks when the proceeds were to be used by the nonmembers in the buying, selling, or carrying of government obligations floated for the purpose of financing the war.[10] During this period the statute was

[8] *Fed. Res. Bull.*, August 1, 1915, p. 213.

[9] *Ibid.*, June 1, 1918, p. 520.

[10] *Fed. Res. Bull.*, June 1, 1917, p. 426; also *Ibid.*, July 1, 1917, p. 497–498.

applied very liberally and considerable rediscounting of nonmember paper was done.

That it has been very difficult to make the discrimination which the Federal Reserve Board believes necessary is shown by the following testimony of the late Governor Strong, of the Federal Reserve Bank of New York, before the Joint Commission of Agricultural Inquiry:[11]

"The Federal Reserve act provides that member banks shall not act as agents for nonmembers in securing credits from reserve banks, except after having secured the permission of the Federal Reserve Board. But, how can you distinguish it? Let us suppose that a State bank, not a member of the Federal reserve system borrows money from a national bank, which is a member, and that the national bank at the same time, possibly because of this borrowing by the State bank, comes to us for a loan to increase its reserve which has been impaired by that very borrowing; that is, the loan made by it to the State bank. The loan is such as would ordinarily be made by one bank to another. And, if we make a loan to that national bank, we are providing it with funds, indirectly, to enable it to make a loan to a State bank."

"It is a fact that certain loans may come to the reserve banks through the agency of member banks, with which the State banks have never had any relation whatever, just acting as a go-between, and the member banks may indorse the paper (as they would have to, in order to get the discount) for a consideration, for a commission, or for a difference in interest rates, and then turn the funds right over to a State bank which thus employs the member bank as an agent. But if we were to attempt to prevent the employment of the funds of the Federal reserve bank for the purpose of making loans to nonmember banks; if we were to prevent member banks doing that, we would have to go into their offices and examine every loan that they made or require from them a certificate that they make no loans to nonmember banks, in order that our funds might not be indirectly used for nonmember bank purposes."

"That same principle applies to all transactions between reserve banks and member banks. We can not earmark these dollars we lend, so to speak, to the member banks, and say that

[11] Hearings before the Joint Commission of Agricultural Inquiry, part 13, p. 697–698.

so much shall go to the State banks and so much to the farmers, and so much to other purposes."

Governor Strong went on to say that the only practicable method of control lay in securing the cooperation of the member banks. If a more complete control over "backdoor relief" was desired, it would mean that the federal reserve bank would have to maintain a representative in each one of the member institutions for the purpose of examining every loan.

In the middle of 1921 the Federal Reserve Board announced that it would, until further notice, permit member banks and trust companies to act as agents for the nonmembers in rediscounting eligible paper at the federal reserve banks.[12] The reason which has been generally given for this action is that such permission was necessary to strengthen the banking situation during the depression existing at that time. It has been claimed that the opening of the resources of the federal reserve system to the nonmembers at this time saved many of them from acute financial embarrassment. It also is said to have greatly relieved agricultural communities. This may be true. But if the nonmembers can expect to get permission to resort in this manner to the reserve banks in time of widespread financial difficulties one of the greatest incentives to membership is removed. Some of the member institutions complained that it was unfair to them to permit the nonmembers to benefit in this way since they had contributed nothing to the support of the system. On June 26, 1923, the Federal Reserve Board rescinded the order permitting the members to act as agents for nonmembers, and announced that hereafter this would be allowed only upon special permission of the Board. The federal reserve banks would still be permitted to discount bankers' acceptances or other eligible paper bearing the signature or indorsement of nonmembers if such paper was bought by the bank offering it

[12] *Fed. Res. Bull.*, August 1, 1921, p. 963.

for rediscount in good faith on the open market from some other party than the nonmember institution whose name it bore. The Board announced that any member desiring to rediscount paper acquired from nonmembers would be called upon to justify such action, and that permission to rediscount would generally be refused where the paper was that of an eligible nonmember. Exceptions might be made in special cases, but if the nonmembers desired to share in the benefits of the system they should join and take on the responsibilities of membership, concluded the Board.[13]

While the withdrawing of this permission did to some degree prevent the nonmembers from sharing in the benefits of the system from the outside, members still give aid indirectly where they wish. As Governor Strong has pointed out, it is almost impossible to discover whether the proceeds of rediscounting are put at the disposal of nonmembers by the members. The extending of "bootleg credit" through the "back door" of the system is almost impossible to prevent. Many members find it profitable to assist the nonmembers in this way because of a slight commission on such loans and desire to continue doing so. But borrowing in this way makes rates higher for the business man or farmer, because of the expense of an intermediary. Where members obtain the funds for the nonmembers by borrowing on government obligations from the reserve banks the prevention of this practice becomes much more difficult. So long as so many members refuse to stop this practice most of the nonmembers will continue to remain outside of the federal reserve system.

Many members, however, are not so anxious to assist the nonmember state banks and trust companies. They believe that if they no longer act as correspondents for the country nonmembers they can enter into competition with them for much of their business. A number of them have done so. Some nonmembers desire to prevent the break-

[13] *Fed. Res. Bull.*, August, 1923, p. 891.

ing of relations with their city correspondents for this reason.

One reason why the city correspondents have been able to take care of the country banks is that the demand for bank credit until the latter part of 1927 has been of a moderate nature. Many of the country banks have not been pressed for additional funds to such an extent that they must rediscount with or borrow from other banks on a large scale. One reason for the increase in membership during 1919 and 1920 was that many banks desired to be in a position to secure additional funds because of the great expansion in loans. This pressure has been largely absent during the past few years. This fact removes much of the need for joining the system. What funds have been needed have been secured through correspondents.

A comparison between loans and discounts made by the federal reserve banks in 1920 and at present illustrates this point. On December 3, 1920, bills, other than those secured by government obligations, rediscounted by the federal reserve banks amounted to $1,616,116,000.[14] The peak of the loans secured by government obligations was reached on May 29, 1919, when the federal reserve banks held $1,802,893,000 of such paper.[15] On November 5, 1920, the reserve banks held $1,215,100,000 of bills secured by government obligations and $1,611,724,000 of bills otherwise secured, a total of $2,826,825,000, the largest combined total ever held.[16]

The average daily holdings of discounted bills since 1920 are: [17]

1920	$2,530,379,000	1924	$ 374,834,000
1921	1,804,305,000	1925	481,515,000
1922	573,247,000	1926	571,000,000
1923	738,114,000		

[14] Fed. Res. Board, 1920, p. 139.
[15] 6 Fed. Res. Board, 1919, p. 112.
[16] 7 Fed. Res. Board, 1920, p. 139.
[17] 12 Fed. Res. Board, 1925, p. 60; 13 *Ibid.*, 1926, p. 55.

These figures show clearly that the demand for funds from the federal reserve banks has declined considerably during the years since 1921. Undoubtedly this has been an important factor in lessening the desire to enter the system. A recurrence of the conditions prevailing during 1920 would no doubt result in an increase in the number of enrollments.

Under such conditions it is difficult to condemn the actions of the non-national banks. But they should not be surprised to find some day that their city correspondents were not able to help them enough to ward off disaster. Direct membership in the federal reserve system would put them in a safer position, where they could always be sure of assistance. Some authorities feel that the city member is thoroughly justified in advising its country correspondent to stay out. It is argued that the city bank has fulfilled its duty by joining, although if it was a national bank it could not have done otherwise. The city bank, it is said, engages in business for a profit, it expects and deserves to make money out of its relationship with the customers, and the country banks are among its regular customers. Why, then, should there be any complaint?

The answer, must of course be found in a reassertion of the ultimate purpose of the federal reserve system. The test to be applied is whether such conduct runs contrary to the welfare of the general business and banking public. Is not the city bank encouraging its country correspondents in a course which is unwise and unsound from the long run point of view? The conclusion cannot be avoided that it is so doing.

Closely allied to the foregoing contentions is the assertion of many nonmembers that they have absolutely no need for the facilities of the system because they never do any rediscounting, never borrow from anyone, and consequently are perfectly able to take care of themselves. They point to the fact that many members seldom use the federal

reserve banks. To these banks membership seems to offer no advantage whatever. This may all be true, but these members are living under conditions much more stable than before the establishment of the federal reserve system. What they forget is that their present safety has been brought about by and rests largely upon the continuance of that system. They let other banks bear the burden of making banking safer for them, and then because conditions are less perilous they refuse their direct support to the institution making it so. Is this sound banking foresight?

II

The most frequent objection raised to membership in the system is the non-payment of interest on the reserves deposited with the federal reserve banks.[18] It is unfortunate that interest bearing reserves have been permitted for so long by American banking laws. As a result bankers feel that they are entitled to receive interest on at least a part of their reserves. A number of bills have been introduced in Congress for the purpose of compelling the federal reserve banks to pay interest on their reserve deposits, but fortunately have not been enacted into law.[19]

Two questions are involved in the discussion of this problem. First, would it be advisable so to amend the law as to permit the wishes of the banks to be granted? Second, does the nonpayment of interest mean that a net loss results to the member institution?

[18] The reports of the federal reserve agents, the examination conducted by the Guaranty Trust Company of New York in 1916, the letters published by the various federal reserve banks containing the experiences of members, the letters published in the Journal of the American Bankers' Association for June and August, 1919, and the investigation of the Joint Congressional of Inquiry into Federal Reserve Membership all reveal this beyond dispute.

[19] Bills of this nature were H. R. 12849, introduced by Mr. Goodykoontz of West Virginia, March 1, 1920; also S. 3773, introduced by Senator Gore (by request) Jan. 22, 1920. *Journal A. B. A.*, Nov., 1920. p. 277; more recently the Fulmer bill made similar provisions.

A. The answer to the first question must be emphatically in the negative. The payment of interest would result in a defeat of the main purposes for which the federal reserve system was established. It is not for the purpose of increasing the earning power of banks that bank reserves are required, but for the safety of the banking community. An officer of the Guardian Trust and Savings Bank of Toledo, Ohio, one of the first state institutions to join, made the following statement with regard to interest bearing reserves: [20]

> "It seems to me that bankers all over the country, national as well as state, have lost sight of the great benefits of the system through not being able to lose sight for a moment of the direct disadvantage to them; i. e. the loss of interest on that portion of their reserve which they keep with the Federal Reserve Bank. . . . We are convinced, however, that the old national bank reserve system was unscientific and in every way improper, for we do not believe that an interest-bearing balance can ever be a real bank reserve, and in our opinion the education of the present day banker to look upon an interest bearing balance as a reserve has done incalculable harm and we will not obtain proper cooperation for the building up of the Federal Reserve System until bankers become convinced that such a reserve is not a proper one and reconcile themselves to some loss of revenue in order to obtain a real reserve."

The Aldrich plan did not permit payment of interest on deposited reserves. No central bank in any important country pays such interest. It has long been held to be directly contrary to sound central reserve banking principles.

If payment of interest was required it would mean that the federal reserve system would be compelled to adopt a policy which had as its main object the earning of enough profit to make the payments. But the federal reserve banks were not established for profit making purposes. The adoption of profit making as a policy would mean that the funds

[20] *Fed. Res. Bull.*, May 1, 1917, p. 365.

of the reserve banks must be kept invested in such a way as to destroy their availability in time of need. It has frequently been stated that the profit making policy is not necessary, that interest need only be paid when earned in the natural course of the operations of the reserve banks. This proposal is less objectionable than the fixing of a definite rate of interest to be paid each year, but it is nevertheless dangerous for the reason that a clamor might arise for the adjustment of the operations of the reserve banks to make payment a certainty. This would be much to be regretted. Not only would it compel the reserve banks to extend their open market operations and enter into more direct competition with their member banks, but it would lead to complaint and criticism in years when interest was not earned. It would mean a departure from the principles upon which the reserve banks were established, and lead to the concentration of attention upon the profit and loss statements of these institutions instead of upon the measures necessary to preserve the stability and security of the banking situation.

The situation before the passage of the Federal Reserve Act has been well described by Mr. Pierre Jay, formerly federal reserve agent at New York, in the following words: [21]

"We had more than one clear demonstration that but very limited credit elasticity resulted from depositing the reserves of commercial bank A with commercial bank B. For the B banks acting as reserve agents for the A banks, were compelled by competition to allow interest on deposits; and in order to earn enough to pay both interest to depositors and dividends to stockholders were obliged to keep their funds invested fairly close to the legal limit. Consequently, when any sudden demand for credit arose there was found to be but little reserve credit-making power in these banks; different groups of borrowers competed with one another for such credit as was available; interest rates rose sharply; on certain acute occasions the banks had

[21] *Journal A. B. A.*, August, 1919, p. 72.

to create the additional credit required through the medium of clearing house certificates; and the panics or stringencies which usually accompanied such action set industry back for months or years and caused untold losses to the business and labor of the country. Our bankers and our statesmen finally agreed that the situation called for an assembling of bank reserves into a reservoir of such size and strength that there would never be any question of its ability to provide all the credit which any sudden demand might require without having to curtail existing credits to meet the new demand. The Federal reserve system was accordingly created, primarily for this purpose."

Similar evils might develop in periods of financial stress were the federal reserve banks compelled to keep a large part of their funds continually invested for the purpose of earning profits to pay interest. Had the system been required to pay interest from its beginning, said Mr. Jay, it might have been compelled to increase its investments to such an extent that the reserve banks would have been in a much weaker position for assisting in the successful financing of the war.

Since one of the important functions of the federal reserve banks is to stabilize credit conditions they should always be in a position to act with freedom in using their funds to increase or decrease the amount of available credit. But when credit conditions became easy the reserve banks would have to invest all the more of their funds in order to earn a large enough sum for interest payments. This would lower the interest rates and decrease the earnings of the member banks and draw violent protests from them, and make credit conditions more unstable than ever.

Of course, it might be replied that no such policy need be adopted. Many argue that interest need only be paid when in the ordinary operation of the system there are enough earnings available, that the extra earnings which now are paid to the government as a franchise tax should instead be returned to the banks. But it is hard to avoid the conclusion that it would be extremely difficult to con-

tinue such a policy without reaching a condition where profit making was an essential part of federal reserve policy.

The large profits made by the reserve banks during the war period were responsible for an increase in the agitation for the payment of interest. A number of state bankers' associations passed resolutions advocating amendments to the law to make such payments, many commenting at the same time upon the huge earnings of the reserve banks. At the meeting of the Executive Council of the American Bankers' Association in May, 1921, there was appointed a sub-committee to suggest a suitable way for disposing of the earnings. This sub-committee submitted the following resolutions:[22]

> "Whereas, the Federal Reserve banks are making larger profits than was originally contemplated, and
>
> "Whereas, the said profits are being made on the reserves of the member banks, and
>
> "Whereas, other interests of the country are endeavoring to have these profits diverted to channels other than banking interests,
>
> "Therefore Be It Resolved, That Congress be petitioned to amend the Federal Reserve Act in such a manner as to provide for the payment of interest to the member banks on their required reserves—the rate of this interest to be fixed by the Federal Reserve Board, based on the profits arising from the operation of the banks, as contemplated by the Act, without entering into competition with the said member banks."

This resolution was submitted to the Economic Policy Committee of the Association, but this committee did not approve of the attitude expressed. The wording of the resolutions shows that while the bankers desire interest they are afraid that the federal reserve banks might enter into competition with the members in order to earn enough to make the payments.

During the first two and a half years of the system interest payments would have been out of the question.

[22] *Com. and Fin. Chron. Supp.*, Oct. 29, 1921, p. 133.

The reserve banks did not earn enough even to pay dividends. On December 30, 1915, the paid-in capital of the reserve banks was approximately $55,000,000 and the reserve deposits came to approximately $400,000,000. Only the Federal Reserve Banks of Richmond and Dallas paid any dividends, and the total excess of earnings for the whole system over the current expenses was only $640,000. By the end of the next year the capital had increased to $55,700,000 and the reserve deposits to $672,000,000. While all of the reserve banks paid some dividends that year the net earnings were only about $2,751,000 or about 5 per cent on the average capital for that year. Only three of the reserve banks earned over 6 per cent, five earned between 5 and 6 per cent, two earned over 4 but less than 5 per cent, and two less than 4 per cent.[23] On December 31, 1917, the capital had grown to $70,700,000 and reserve deposits to $1,500,000,000. The combined earnings for this year were $11,203,000. The required 6 per cent dividend is cumulative so with these earnings St. Louis and San Francisco paid up their dividends to December 31, 1916; Philadelphia, Kansas City, Cleveland, and Dallas paid up to June 30, 1917; the six other reserve banks in New York, Boston, Richmond, Atlanta, Chicago, and Minneapolis being able to complete payments up to the end of 1917. After charging off depreciation and setting aside the required surplus only $1,134,234 was left for payment to the government as a franchise tax.[24] In 1918, the net earnings were $55,447,000. Reserve deposits had increased to $1,635,000,000 by December 31. The earnings were large enough to permit dividends to be paid up to date by all of the reserve banks, and $26,728,000 was set aside for payment to the government as a franchise tax.[25]

On March 3, 1919, the Federal Reserve Act was amended to provide that, after the payment of the 6 per

[23] 3 Fed. Res. Board, 1916, pp. 13, 84, and 116.
[24] 4 Fed. Res. Board, 1917, pp. 28 and 92.
[25] 5 Fed. Res. Board, 1918, p. 209.

cent dividends, the net earnings were to be paid into surplus until a surplus of 100 per cent of the subscribed capital of the entire system had been accumulated. Thereafter 10 per cent of the earnings were to be carried to surplus annually, while the remainder was to be paid to the government as a franchise tax. This amendment was made applicable to the earnings of 1918, so the amount which had been set aside for the government for that year was instead carried to surplus.

Up to the first of 1919, then, only about $28,000,000 would have been available for distribution in interest. After the 1919 amendments this was no longer available.

Earnings from 1919 on are shown by the following table:

Year	Net earnings available for dividends, surplus, and franchise tax	Dividends Paid	Paid to government as franchise tax
1919	$ 78,367,000	$5,012,000	$ 2,704,000
1920	149,295,000	5,654,000	60,724,000
1921	82,087,000	6,120,000	59,974,000
1922	16,498,000	6,307,000	10,851,000
1923	12,711,286	6,553,000	3,613,000
1924	3,718,180	6,682,000	114,000
1925	9,449,000	6,916,000	59,000
1926	16,611,745	7,329,169	818,150
1927	13,048,248	7,754,538	249,591

From the establishment of the federal reserve system up to the end of 1927 the following distribution has been made of net earnings: [26]

Dividends paid	$ 72,630,083
Transferred to surplus	233,819,552
Franchise tax paid United States government	140,241,684

From 1918 through 1921 considerable sums might have been distributed to the members. The amount paid to the

[26] 12 Fed. Res. Board, 1925, p. 117; 13 *Ibid.*, 1926, p. 126; *Fed. Res. Bull.*, Feb., 1928, p. 165.

government as a franchise tax would, by itself, have increased the earnings of the member banks appreciably had it gone to them. Since 1922, however, the earnings of the reserve banks have decreased to such an extent that the amount available for distribution to members would have been negligible. In 1924, for example, most of the reserve banks paid their dividends out of surplus. If the profits of the reserve banks average for the next few years the same as they have for the last three there would not be enough earnings to distribute to bother about unless no further payments are made to surplus. It would seem that this is the best answer to those who demand interest on their reserve deposits.

When the Joint Congressional Committee of Inquiry on Federal Reserve Membership was holding its hearings in 1923 there appeared before it a number of witnesses who favored a distribution of profits to member banks. At that time the profits for the previous years had been extremely large, as a result of credit expansion during the war. It seemed as if there was really something there to get.

A delegation of New England bankers argued before the commission that earnings could be distributed in this way. From the net earnings, first, pay the 6 per cent dividends, to member banks. Next, subtract a sum equivalent to 2 per cent of the federal reserve notes that are uncovered by gold and turn this over to the Federal government as a tax. This should go to the government to reward it for standing back of the uncovered notes. The amount left should be divided among the members in proportion to their reserve balances. This plan is probably the least objectionable of all that have been proposed.

When it was argued that the amount given to the members would be so small that it would increase their earnings only slightly the bankers replied that such a plan would at least show a spirit of fairness and create a better feeling among the members. It would, they claimed, make

the members more interested and induce them to give more attention to the earnings and activities of the reserve banks.

When it was further argued that as a result the reserve banks would be more eager to lend or advance rates when neither was desirable in order to increase earnings the bankers replied that there would be a check on these methods should they be used. For example, increased lending would drive down the rates that could be charged by all banks and the members would, therefore, oppose such tactics instead of demanding increased earnings of the reserve banks. If the attempt was made to raise rates this increase must be approved by the directors of the reserve bank and the Federal Reserve Board. Since many of the directors are business men borrowing considerable sums from their banks they would endeavor to check any unreasonable increase in rates.[27]

This proposal, coming from a section of the country where conservative banking has long been the rule attracted wide attention. It had the support, apparently, of Alfred L. Aiken, the first governor of the Federal Reserve Bank of Boston, and of W. P. G. Harding, its present governor and former governor of the Federal Reserve Board. Governor Harding argued that since the stockholders in the Federal Farm Loan Banks received a share of their earnings it was certainly not amiss to adopt a similar policy with regard to the stockholders in the reserve banks.[28] There seems to be no compelling reason why the government is entitled to a certain share of the profits of the reserve banks beyond a tax on the uncovered notes.

Additional justification for division of profits is sometimes found in the fact that the Glass bill, creating the federal reserve banks, passed the House the first time with a provision that 40 per cent of the surplus profits should go to the members.

[27] See *U. S. Investor*, Oct. 20, 1923, p. 131 (Vol. 34, p. 2483).

[28] Lewis, Reuben A., "The Movement for a Division of Federal Reserve Earnings" *Journal A. B. A.*, Dec., 1923, pp. 360-361.

The plan of the New England bankers is the least objectionable of any which have been proposed, with the possible exception of a proposal which advocates giving only 50 per cent of the profits to the members. The 6 per cent dividend would be included in the 50 per cent going to members. Such a scheme is supported by former Governor M. G. Wellborn of Atlanta.

It is clearly evident that a number of the governors of the Federal Reserve Banks, Governor Seay of Richmond in addition to Governors Wellborn and Harding, believe that a more liberal division of federal reserve earnings is imperative if the goodwill of the members is to be maintained. They argue that since city banks pay interest on reserve deposits of their country correspondents the reserve banks must take a more liberal attitude if the system is not to suffer.[29]

The dangers in such a course have been outlined. It is of course impossible to pay any set percentage of interest. The earnings of the reserve banks have not been large enough since 1922, to pay even 1 per cent on deposits. But an amendment such as that outlined by the New England bankers might not be so objectionable as to prohibit it. It would have to be safeguarded and a constant watch kept against its influencing the system to adopt a profit-making policy. Should it prove an incentive to member banks to increase their business at the federal reserve banks, it would be too dangerous to countenance. There is danger that a zeal for borrowing or rediscounting might develop which would bring far-reaching evils in its train. The type of paper in the portfolios of the reserve banks might deteriorate. As Homer Joseph Dodge once said, "Drumming up business for federal reserve banks is about as pernicious as poisoning wells to make business for undertakers."

Since the decline in federal reserve bank earnings during the past few years less has been heard of proposals for

[29] *Ibid.*

division of earnings. Profits have been too small to make their division of much value to member banks unless payments to surplus are stopped. Furthermore, it is highly doubtful whether many new members would be brought in or old ones restrained from withdrawing by such a change of policy.

B. The next question to be considered is whether the non-payment of interest really results in a net loss to the member institution, when the reduced reserve requirements and the services rendered by the federal reserve banks are taken into consideration. Here the testimony varies greatly, but a large number of the member institutions state that this loss is largely and sometimes completely offset by the advantages which membership offers. Mr. Lucius Teter, President of the Chicago Savings Bank and Trust Company, stated in 1917 that he knew of a bank with deposits of thirty millions which believed that membership would result in a loss, but upon joining found after several months of trial that such was not the case.[30] This was possible, he said, because the actual cash carried in the bank could be reduced considerably after the bank had joined the system, the surplus cash released being invested at a profit. On the other hand, many member banks and trust companies make little use of the facilities of the system, and in spite of the fact that membership in the system generally means permission to carry a lower reserve than that permitted by the state laws, these institutions claim that the net result to them has been a financial loss. The facts justify their claim in some cases.

While nearly all of the states require somewhat larger reserves than are required of member institutions, practically all of the states permit the greater share of the reserves to be carried in other banks, where they become deposits drawing interest of from 2 to 3 per cent. The usual requirement seems to be that the state laws require

[30] 43 Proceed. A. B. A., 1917, p. 353.

a reserve of about 15 per cent against demand deposits, and permit about two-thirds or three-fifths of this to be carried in other banks. A tabulation of the requirements of the states follows: [31]

[31] These requirements are reproduced from a pamphlet "Of Service to Banks and Business" published by the Federal Reserve Board. This table shows several minor differences from the summary published in The Federal Reserve Bulletin for March, 1925, but is chosen because of the more convenient form in which it appears. The differences appear in the requirements listed for the states of Colorado, Connecticut, Florida, Idaho, Louisiana, Maine, Michigan, Oklahoma, Pennsylvania, Texas, and Virginia. The variations are not, however, of great importance.

Reserve Requirements Under State Laws

States marked (*) do not permit State member banks to substitute reserve requirements of Federal Reserve Act. Figures in parentheses refer to footnotes.

	Reserves Required to be Held Upon					Distribution of Reserves	
	Population restrictions	Aggregate deposits	Demand deposits	Time deposits	Savings deposits	Cash in vault	Balances with depositaries
Alabama:							
All banks	None	....	15%	....	....	2/5	3/5
Arizona:							
Savings banks	None	10%	....	....	....	1/4	3/4
Other banks	50,000 or over	20%	....	....	....	1/3	2/3
Other banks	under 50,000	15%	....	....	....	1/3	2/3
Arkansas:							
Reserve agents (35)	None	20%	....	....	....	2/5	3/5
Other banks	None	15%	....	....	....	(38)	(38)
California:							
Savings banks	None	....	....	....	5%	1/2	1/2(1)
Commercial banks	100,000 or over	18%	....	....	....	1/2	1/2
Commercial banks	50,000–99,999	15%	....	....	....	1/2	1/2
Commercial banks	under 50,000	12%	....	....	....	1/2	1/2

Colorado:							
Savings banks	None	20%(2)	....	....	15%	1/5	4/5(3)
Reserve agents (35)	None	25%	....	....	....	1/5	4/5(4)
Other banks	None	20%	....	....	....	1/5	4/5(3)
*Connecticut:							
State banks and trust companies	None	....	12%	5%	....	1/3	2/3(5)
Delaware:							
Banks and trust companies	None	....	10%	5%(38)	5%(38)	1/3	2/3(39)
Savings banks	None	5%	....	....	....	(38)	(39)
*Florida:							
All banking companies	None	20%	....	....	....	2/5	3/5(6)
Georgia:							
All banks	None	....	15%	5%(7)	5%(7)	(38)	(38)
Idaho:							
State banks	None	15%	....	....	....	1/5	4/5
Trust companies	None	15%	....	....	(8)	1/5	4/5
*Illinois:							
Banks and trust companies	Chicago	25%(9)	....	....	....	(38)	(38)
Banks and trust companies	Elsewhere	15%(9)	....	....	....	(38)	(38)
*Indiana:							
All banks and banking companies	None	....	12½(10)	....	....	(38)	(38)

RESERVE REQUIREMENTS UNDER STATE LAWS—*Continued*

States marked (*) do not permit State member banks to substitute reserve requirements of Federal Reserve Act. Figures in parentheses refer to footnotes.

	Reserves Required to be Held Upon					Distribution of Reserves	
	Population restrictions	Aggregate deposits	Demand deposits	Time deposits	Savings deposits	Cash in vault	Balances with depositaries
Iowa:							
State banks, trust companies, and savings banks doing commercial business	3,000 or over	....	20%	8%	8%	3/20	17/20
State banks, trust companies, and savings banks doing commercial business	Under 3,000	....	15%	8%	8%	3/20	17/20
Other savings banks	None	....	....	....	8%	3/20	17/20
*Kansas:							
State banks	50,000 or over	....	10%	3%	....	1/3	2/3
State banks(11)	Under 50,000	....	10%	3%	....	1/3	2/3
State banks(12)	Under 50,000	....	7%	3%	....	1/3	2/3
State banks	Under 1,000	....	7%	3%	....	1/3	2/3(13)
Trust companies	None	....	25%	10%	....	1/3(14)	2/3(14)
*Kentucky:							
State banks and trust companies	Central Reserve cities(15)	....	13%	3%	....	1/3	2/3
State banks and trust companies	Reserve cities(15)	....	10%	3%	....	1/3	2/3
State banks and trust companies	Elsewhere	....	7%	3%	....	1/3	2/3

*Louisiana:							
State banks	None	....	20%	....	....	1/5(16)	4/5
Maine:							
Trust and banking companies	None	....	15%(17)	....	....	....	All(13)
Maryland:							
State banks	None	....	15%	....	....	1/3	2/3
Trust companies	None	....	15%	....	....	....	All(19)
Massachusetts:							
Trust companies	In Boston within 3 miles of State House	....	20%	....	....	2/5(20)	3/5(20)
Trust companies	Elsewhere	....	15%	....	....	2/5(20)	3/5(20)
Michigan:							
Commercial banks	100,000 or over	20%	....	....	....	(38)	(38)
Commercial banks	Under 100,000	12%	....	....	....	(38)	(38)
Savings banks	None	12%	....	....	....	(38)	(38)
*Minnesota:							
State banks	Residence cities(35)	....	15%	5%	....	1/4	3/4
State banks	Elsewhere	....	12%	5%	....	1/4	3/4
Mississippi:							
State banks	over 50,000	....	25%	10%	10%	(38)	(38)
State banks	Elsewhere	....	15%	7%	7%	(38)	(38)

RESERVE REQUIREMENTS UNDER STATE LAWS—*Continued*

States marked (*) do not permit State member banks to substitute reserve requirements of Federal Reserve Act. Figures in parentheses refer to footnotes.

	Reserves Required to be Held Upon					Distribution of Reserves	
	Population restrictions	Aggregate deposits	Demand deposits	Time deposits	Savings deposits	Cash in vault	Balances with depositaries
Missouri:							
State banks and trust companies	200,000 or over	....	18%	....	....	7/18	11/18
State banks and trust companies	25,000 to 199,999	....	15%	....	....	2/5	3/5
State banks and trust companies	Under 25,000	....	15%	....	....	(38)	(38)
Montana:							
State banks	Res. cities(35)	15%	....	....	....	(21)	(21)
State banks	Elsewhere	10%	....	....	....	(21)	(21)
*Nebraska:							
State banks	Over 25,000	20%	....	....	....	2/5	3/5
State banks	Elsewhere	15%	....	....	....	1/3	2/3
Savings banks	None	....	....	....	5%	(38)	(38)
Nevada:							
Reserve agents(35)	None	25%	....	....	....	1/3	2/3
Other banks	None	15%	....	....	....	1/3	2/3
Savings banks and trust companies not doing general banking business	None	10%	....	....	....	1/2	1/2

New Hampshire:							
All banks	None	15%(37)	....	....	....	1/3	2/3
New Jersey:							
State banks	None	....	....	....	....	2/5	3/5
Trust companies	None	....	....	....	....	1/5	4/5
New Mexico:							
All banks	None	12%	....	....	....	(25)	All
New York:							
State banks	Boroughs of 2,000,000 or over	....	18%	....	....	2/3(24)	1/3
State banks	Boroughs of 1,000,000 to 1,999,999(23)	....	15%	....	....	2/3(24)	1/3
State banks	Elsewhere	....	12%	....	....	1/3(24)	2/3
Trust companies	Boroughs of 2,000,000 or over	....	15%	....	....	2/3(24)	1/3
Trust companies	Boroughs of 1,000,000 to 1,999,999(23)	....	13%	....	....	8/13(24)	5/13
Trust companies	1st and 2nd class cities under 1,000,000	....	10%	....	....	2/5(24)	3/5
Trust companies	Elsewhere	....	10%	....	....	3/10(24)	7/10
Private bankers	Cities of 1st class	....	15%	....	....	1/10	9/10
Private bankers	Elsewhere	....	10%	....	....	1/10	9/10

RESERVE REQUIREMENTS UNDER STATE LAWS—*Continued*

States marked (*) do not permit State member banks to substitute reserve requirements of Federal Reserve Act. *Figures in parentheses refer to footnotes.*

	Reserves Required to be Held Upon					Distribution of Reserves	
	Population restrictions	Aggregate deposits	Demand deposits	Time deposits	Savings deposits	Cash in vault	Balances with depositaries
North Carolina:							
Banks and trust companies	None	....	15%	....	5%	(25)	(38)
*North Dakota:							
Savings banks	None	....	20%	8%(26)	5%(27)	2/5	3/5
State banks	None	....	10%	7%	....	2/5	3/5
Ohio:							
Commercial banks	None	15%	....	....	....	4/15 demand 2/15 time	11/15 demand 13/15 time
Savings banks and trust companies	None	....	15%	10%	....	4/15 demand 2/10	11/15 demand 8/10
*Oklahoma:(28)							
State banks	Over 2,500	20%	....	....	....	1/3	2/3
State banks	Under 2,500	15%	....	....	....	1/3	2/3
Reserve banks	None	20%	....	....	....	1/3	2/3
Savings banks not doing general business	None	20%	....	....	....	1/2	1/2(6)

Oregon:							
State banks and trust companies	None	. . .	15%	10%	10%	1/4	3/4
Pennsylvania:							
All banks	None	. . .	15%(22)	7½%	. . .	1/3 demand time(30)	2/3 demand(29) time(30)
*Rhode Island:							
State banks and trust companies	None	15%	. . .	. . .	. . .	2/5	3/5
South Carolina:							
All banks	None	. . .	7%	3%	. . .	(38)	(38)
South Dakota:							
Reserve banks(35)	None	20%	. . .	. . .	. . .	(38)	(38)
Other banks	None	17½%	. . .	. . .	. . .	(38)	(38)
Tennessee:							
State banks and trust companies	None	. . .	10%	. . .	. . .	(38)	(38)
Texas:							
Banks—capital $25,000 or over	None	. . .	15%	. . .	. . .	(38)	(38)
Other banks	None	. . .	20%	. . .	. . .	(38)	(38)
Utah:							
Commercial banks	50,000 or over	20%	. . .	. . .	. . .	1/8	7/8
Commercial banks	Under 50,000	15%	. . .	. . .	. . .	1/8	7/8
Savings banks	None	10%	. . .	. . .	. . .	1/4	3/4
Vermont:							
All banks	None	. . .	15%(10)	. . .	3%	1/5(31)	4/5(29)

RESERVE REQUIREMENTS UNDER STATE LAWS—*Continued*

States marked (*) do not permit State member banks to substitute reserve requirements of Federal Reserve Act. Figures in parentheses refer to footnotes.

	Reserves Required to be Held Upon					Distribution of Reserve	
	Population restrictions	Aggregate deposits	Demand deposits	Time deposits	Savings deposits	Cash in vault	Balances with depositaries
*Virginia:							
State banks(32)	None	....	10%	3%	....	(38)	(38)
Washington:							
State banks and trust companies	None	15%(33)	....	....	....	(38)	(38)
West Virginia:							
State banks and trust companies	None	....	15%	....	....	2/5	3/5
Savings banks	None	....	....	....	5%(34)	All(34)	....
Wisconsin:							
Reserve banks	None	20%	....	....	....	(38)	(38)
Other state banks and trust companies	None	12%	....	....	....	(38)	(38)
Mutual savings banks	None	....	....	....	5%	(38)	(38)
*Wyoming:							
Commercial banks and trust companies	None	20%(36)	....	....	10%	(38)	(38)
Savings banks	None	....	....	....	10%	(38)	(38)

(1) Or in U. S. bonds.
(2) Deposits other than savings.
(3) 6% deposits may be in Liberty bonds.
(4) 7½% deposits may be in Liberty bonds.
(5) ¼ of balances may be in approved bonds.
(6) Or approved bonds.
(7) Reserve against time and savings deposits may be in unpledged U. S. or Georgia bonds.
(8) Not less than 5% as cash in vault.
(9) Ruling of auditor—not state law.
(10) Commercial deposits payable on demand and subject to check.
(11) Banks having 20% or more of deposits due to banks.
(12) Banks having less than 20% of deposits due to banks.
(13) ¼ of reserves as cash with approval of banking commissioner.
(14) U. S. bonds and demand loans secured by U. S. or municipal bonds accepted as reserve.
(15) As designated by Federal Reserve Act.
(16) Member banks balances with Federal reserve bank accepted as cash in vault.
(17) Including deposits subject to notice within 10 days.
(18) ⅓ may be in U. S. or Maine bonds.
(19) ⅓ may be in bonds.
(20) ½ of cash and ⅓ of balances, or in all ⅖ of total reserve, may be in approved bonds.
(21) Such portion of reserve as directors may determine may be on deposit with approved reserve agents, balance in cash.
(22) All items or claims payable on demand.
(23) If bank does not have office in borough of preceding class.
(24) Prescribed percentage may be on deposit with Federal reserve bank.
(25) No requirements as to cash in vault: all may be carried with reserve agents.
(26) Total deposits on time certificates.
(27) Deposits subject to notice as provided by law.
(28) No specific law exists permitting state member banks to substitute Federal reserve in lieu of state requirements, but state authorities do not criticize such substitution.
(29) ½ of balances may be in approved bonds.
(30) ⅓ in approved bonds, ⅔ in cash or balances.
(31) ½ of cash may be deposited in bank in same town or county.
(32) State law by implication permits state member banks to comply with reserve requirements of Federal Reserve Act.
(33) Reserve of 100% required against uninvested trust funds.
(34) Set aside from profits and held as cash.
(35) As defined by state law.
(36) Liability to depositors other than savings.
(37) Deposits in banking or commercial department.
(38) Reserves consist of cash in vault and balance with approved reserve agents, no provision being made for definite distribution between the two.
(39) Upon approval of banking commissioner one-half of reserves may be in bonds or other obligations of the United States.

At first glance it might seem that membership would enable a bank to decrease considerably the amount of reserve carried. Most states require a reserve of from 15 to 20 per cent while the federal reserve system requires only 7 or 10 per cent of demand and 3 per cent of time deposits for all banks not in New York or Chicago. But the foregoing table shows that most of the states require a reserve of only about 6 per cent to be carried in the vaults of the bank. Some states, Illinois, Indiana, Michigan, Nebraska, and Wisconsin among others require no definite portion to be carried in the vault. The majority of the reserves may be on deposit in other banks and these deposits bear from two to three per cent interest. Furthermore, a large share of the reserves of nonmembers is made up of "float," checks in process of collection. These may be counted as legal reserve in many states the moment the checks are mailed to the correspondent for collection. No interest is paid by the correspondent on this sum until the checks are actually collected, but the advantage to the country banks in this relationship is obvious. If the bank joined the federal reserve system this "float" would cease to count as reserve until actually collected. Finally, a member must keep all of its reserve with its federal reserve bank. The advantages of membership, therefore, may not be so great as might be imagined from superficial study.

Whether or not there will be a decline in earnings upon joining the system seems to rest upon several factors: whether the institution is able to decrease considerably the amount of cash kept on hand, whether the surplus cash released can be profitably and safely loaned, whether the member is compelled at times to resort to outside assistance, and whether it has decreased the amount of the balances with its correspondents. Where the member had not fulfilled these conditions there is a likelihood that membership will mean a decrease in its profits. It is claimed that many members have not decreased their cash on hand as

much as possible and have not cut down their balances with correspondents as much as they could have done. Where the omission of these changes results in loss to the member it seems hardly fair to blame the federal reserve system for something which results from the inertia of bankers or their failure to readjust their banking practices so as to take full advantage of the facilities of the federal reserve system. Valuable evidence is obtained from the actual experiences of banks such as the Citizen's State Bank of South Haven, Michigan. Its President, in 1920, made the following statement: [32]

"The Citizens State Bank of South Haven joined the Federal Reserve System in October, 1918, and at that time our deposits were approximately $650,000, on which we were obliged by State law to carry 15% reserve, or $97,500. In order to properly handle our business, however, it was necessary to carry a reserve of over $100,000, of which $35,000 was cash in vault. This excess reserve was necessary because of the accommodations required from our commercial correspondents. They collected for us at par all out of town checks and, in addition, loaned us funds to care for our local demands.

"Since joining the Federal Reserve System our deposits have increased from $650,000 to nearly $1,000,000, and our reserve requirements have been reduced from 12% on all deposits to 7% on our demand and 3% on our time deposits, or from $120,000 to $50,000. In addition, the amount of cash needed in vault has been reduced very materially, as we are able to get currency from the Federal Reserve Bank on very short notice.

"To offset the loss of interest on our balance of $50,000 carried with the Federal Reserve Bank, you collect for us at par checks on about 25,000 banks, ship to and receive from us currency without any expense, and loan us funds at reasonable rates to care for our local demands.

"In addition to the above, by having our reserve requirements reduced, we have released for loaning purposes about $75,000 which was formerly carried with commercial corre-

[32] Membership in the Federal Reserve System from the State Bank Viewpoint, Letter No. 4. Federal Reserve Bank of Chicago.

spondents at 2¼% interest. We now receive interest of 7% on this amount.

"The benefits received through the additional security furnished to our stockholders, depositors and borrowers and its advertising value cannot be calculated in dollars. Viewed solely as insurance, membership in the Federal Reserve System would be worth while even if it entailed additional expense."

Testimony of this nature might be duplicated from the experience of other members. On the other hand, many members claim that they have not been able to reduce the amount of cash carried on hand. A large number of them, especially in the western, southwestern and northwestern part of the country, claim that they are so far away from the reserve banks or their branches that they cannot borrow and rediscount as conveniently as banks which are located in other sections.

While certain individual members may not find membership profitable it has been shown in Chapter XI that the reduction in reserves brought about by the federal reserve system made possible a large increase in earnings for members as a whole. Before the reserve banks were established state banks carried actual reserves of 23.4 per cent. Member state banks and trust companies now carry approximately 14.7 per cent. Where all state banks formerly held cash in vault amounting to 7.5 per cent of deposits, member state institutions now hold 1.58 per cent. Balances with correspondents are relatively much smaller than formerly.

Reduction in reserves carried by members has been accomplished in another way. All members are permitted to carry only 3 per cent reserve against time deposits. Consequently, there have been all over the country vigorous attempts by banks to transfer large sums from demand to time deposit accounts, so that only 3 per cent need to be kept at the federal reserve banks as reserve instead of 7, 10, or 13 per cent as the case may be. Business firms are induced, wherever it is at all possible, to keep funds, not

immediately needed, in time instead of in demand accounts, and interest is paid on such accounts. The success of these efforts is one of the chief factors responsible for the large increase in savings or time deposits during the past few years. The conclusion is unavoidable that membership has not decreased the earning power of the majority of the member state institutions below what it was before the system was created.

But the trouble is that nonmember banks, profiting by the increased stability resulting from the establishment of the federal reserve system have also cut down their reserves. Formerly they carried on the average 23.4 per cent reserve. Now they hold about 17 per cent. Their cash in vault which formerly was 7.5 per cent now amounts to 3.3 per cent. Increased earnings of something like $20,000,000 should have resulted from the investing of the surplus cash and other reserves released.

Unfortunately, because of the decrease in nonmember bank reserves, nonmembership would now be more profitable than membership in many cases. A comparison between what a bank may now earn as a nonmember with its earning power as a member has under these circumstances induced many banks to withdraw or refuse to join. Had nonmember reserves remained where they were in 1913 the attractiveness of membership would naturally have been much greater. It is extremely unfortunate that the creation of the federal reserve system should have by increasing banking safety at the same time indirectly brought about a situation which renders a further increase in membership most unlikely. The very benefits for which the system is responsible have made it harder to retain and attract members. The non-payment of interest, therefore, may represent the difference between profits as a member and earnings as a nonmember. This will be somewhat offset by the fact that members do carry somewhat smaller reserves than nonmembers.

Non-payment of interest on reserves gives strength to several objections that arise to membership. A number of states have deliberately reduced reserve requirements for their banks. This makes membership even more unprofitable. These changes were made in some cases to lessen any advantage which members might have over nonmembers. Prompted by the jealousy of state bankers and of state banking authorities, this lowering of requirements cannot be regarded as other than unfortunate and unjustifiable.

Membership is made still more unprofitable by the fact that many states still permit "float" to count as reserve. In these states a bank may still count the amount of checks in process of collection as legal reserve. The moment the checks are placed in the mails they become reserve. If these banks enter the system this practice is no longer permissible. Members cannot count "float" as reserve. Availability is deferred until collection is actually made. In addition all of their reserve must be on deposit with the federal reserve bank. Some authorities contend that inability to count "float" as reserve is the chief reason why nonmembers refuse to join. The loss from non-payment of interest joined with the abolition of "float" frequently makes membership expensive.

Another factor complicates the situation. Fifteen states have not yet passed laws permitting state member banks to substitute the reserve requirements of the Federal Reserve act for the state requirements. These states are: Connecticut, Florida, Illinois, Indiana, Kansas, Kentucky, Louisiana, Minnesota, Nebraska, North Dakota, Oklahoma, Rhode Island, South Dakota, Virginia, and Wyoming. While the state banking authorities have in some of these states permitted members to substitute the federal reserve requirements there are jurisdictions where this cannot be done. This makes membership so expensive in some cases that it is clearly inadvisable. Whole-hearted support of the federal reserve system by state banking officials would have

remedied this situation long ago. There is no sound reason why a member bank should be required to keep additional reserves under state law. Compliance with both sets of requirements might decrease earning power considerably.

Some authorities contend that membership in the system allows a bank or trust company to increase its loans to an amount much greater than the surplus cash released. They argue that the cash released can be placed in the federal reserve bank as a reserve, and since the reserve requirement is only 7 or 10 per cent the deposits resulting from increased loans can be increased fourteen or ten dollars for every dollar of reserve placed in the reserve bank. It should be apparent that loans cannot be increased to this extent. As has been pointed out especially by Phillips,[33] a bank attempting to increase its loans in any such wholesale fashion would find itself confronted with large unfavorable clearing house balances. This occurs when the persons who have increased their deposits by borrowing give checks in payment of their obligations to depositors in other banks. Phillips estimates that for every dollar added to the reserve of the bank it can increase its loans only approximately $1.22. If this were not true, a rediscount rate, to be effective, would have to be over 40 per cent to prevent rediscounting at a profit.[34] Even in a period of general expansion the situation would be somewhat the same. The deposits of all banks would increase not only through the granting of loans to their own customers, but also through the deposit by their customers of checks on other banks. The increase in deposits requires larger reserves, and this prevents the expansion in loans which otherwise might seem possible. Phillips proves conclusively that the possibility of profit-making from membership in the system in this respect has been greatly exaggerated.

[33] Phillips, Chester A., *Bank Credit*, Chapters III and VI, New York: MacMillan & Co., 1921.

[34] *Ibid.*, pp. 115–119. For a summary of Professor Phillip's views see *The Annals*, January, 1922, pp. 195–199.

It should be stated that too much stress should not be put upon the prospects of larger profits from membership in the federal reserve system. The possibilities of inflation in our banking system today are so much greater than formerly that any policy tending to produce undue expansion of bank loans for the purpose of making more profits is not to be encouraged. To inform nonmembers that membership will enable them to lend more than they have formerly done may not be wise, when all the facts are taken into consideration.

With regard to actual earnings the state bank and trust company members compare most favorably with the national banks. The ratio of profits to capital and surplus since 1918 is shown in the following table for both types of banks: [35]

	National banks	State bank members
1919	12.11	11.87
1920	12.78	12.92
1921	9.40	11.61
1922	7.79	10.13
1923	8.48	11.52
1924	8.11	11.00
1925	9.00	11.46
1926	9.54	12.71

In every year but one the state bank and trust company members have averaged greater earnings in proportion to their capital and surplus than national banks. This may be explained partly by the fact that the national bank members are of a much smaller average size than the state bank members. It is the small bank that has had the greatest difficulties during the past few years.

A comparison of earnings of state bank and trust company members with those of national banks by districts since 1922 follows:

[35] 12 Fed. Res. Board, 1925, pp. 171 and 173.

RATIO OF NET PROFITS, TO CAPITAL AND SURPLUS

	1926		1925		1924		1923		1922	
	State bank members	National banks	State bank members	National banks	State bank members	National banks	State bank members	National banks	State bank members	National banks
Boston	10.42	9.37	9.61	7.58	9.40	6.89	8.86	8.04	3.26	6.66
New York	15.32	10.86	14.21	11.90	13.53	10.52	13.84	11.47	11.29	9.67
Philadelphia	10.55	11.40	10.98	11.50	11.10	10.91	10.74	11.78	11.09	10.08
Cleveland	9.89	9.25	10.48	10.41	9.46	9.77	11.19	10.26	11.15	9.49
Richmond	8.24	8.34	9.36	7.69	7.98	8.83	8.48	8.84	8.83	8.77
Atlanta	10.70	12.41	9.18	9.12	8.28	8.29	9.59	9.28	7.27	7.88
Chicago	13.55	8.51	11.42	6.88	10.98	7.02	12.87	6.73	12.73	7.88
St. Louis	11.20	8.88	3.70	9.36	7.21	8.07	10.68	8.45	8.43	8.32
Minneapolis	3.43	6.77	3.31	3.68	1.83	1.71	2.17	2.91	2.98	4.95
Kansas City	9.15	5.28	7.02	3.74	8.08	1.22	12.03	3.15	5.82	3.35
Dallas	4.88	9.03	2.96	6.99	4.13	5.58	none	2.94	none	1.32
San Francisco	12.93	8.41	11.87	7.72	11.28	6.91	8.04	6.06	10.21	6.05

Earnings of both classes of banks in the Dallas and Minneapolis districts have been extremely low since 1921. For some reason the national banks in the Kansas City district have shown small earnings. Possibly, were there more state bank members in that district their average earnings might not be so great. This is the district with the smallest amount of non-national members, only about 30.

The state bank and trust company members with the exception of the Dallas and Minneapolis districts show a fairly high level of earnings.

The loss from non-payment of interest may be offset in a number of ways. These have been considered in Chapter XI. They are: establishing part of the reserve out of cash formerly carried in the vaults; lending or investing part of the funds formerly carried with correspondents; the direct routing of checks and par collection; increase in business when the public learns that the bank has joined the federal reserve system; the savings on telegraph and telephone charges and currency shipments; and using the facilities offered by the federal reserve banks for the transfer of funds.

Even where membership has resulted in a loss this loss may well be regarded as insurance against financial embarrassment. A number of bankers have stated that they consider this loss a low premium to pay for the feeling of security which federal reserve membership has brought to them. The rediscounting and borrowing privilege, they consider to be well worth whatever it may cost. Furthermore, this loss does not often amount to a very large sum. A discussion of this question at the Illinois Bankers' Association meeting in 1919 resulted in the conclusion that the majority of the banks which took full advantage of the facilities of the system lost little or nothing, and that those which did lose considered the safety secured to be an offsetting gain.

There are many banking institutions however, for

whom membership would not be advisable, because of the type of business done by them. Some of these institutions, for example, trust companies not doing a large commercial business, joined during the war period because of patriotic reasons, and the non-payment of interest on their balances resulted in a considerable loss to them. A number of them have consequently withdrawn.

It must be concluded that the reported loss from the non-payment of interest on reserve has been exaggerated when earnings are compared with what they would have been had the banks remained under state control. In cases where the state law is especially lenient in its reserve requirements, where a large "float" can still be counted as reserve, where the member engages largely in an investment or trust business, and where cash is not reduced or accounts with correspondents decreased there may be a loss. Individual banks cannot be condemned for not joining when their type of business or the provisions of state laws would render membership expensive. In many cases the fault rests primarily with the state authorities. Whether division of federal reserve profits among members would improve matters much is doubtful. In any event such division of earnings would have to be closely safeguarded.[36]

III

Another reason why so many state institutions have refused to apply for membership is that considerable hostility to the federal reserve system was stirred up by the campaign for the par collection of checks. The history of this controversy is fully treated in the next chapter. It may be claimed that since only 4,000 banks are not on the par list,

[36] In July, 1922, Mr. Appleby of New Jersey introduced a bill in Congress which attempted to solve the dispute by providing for larger dividends to the member institutions on their capital stock of the federal reserve bank. After the surplus of the reserve banks had reached 100 per cent, 10 per cent of the earnings were to be carried annually to surplus, one half of the remainder not to exceed one half of the net earnings were to go to the members as extra dividends.

membership would not affect the practice of the entering bank in this respect. But thousands of the smaller institutions were put on the par list against their will. They remained on the par list because otherwise the federal reserve banks would have kept presenting checks at their counters for payment in cash, and in the end the objecting banks found it was easier to remit at par than to fight the federal reserve system. While remitting at par under compulsion they became very bitter against the whole federal reserve system. Marshall Cousins, formerly banking commissioner for Wisconsin, said in 1920,[37] "I believe this par clearance question has served to irritate to greater extent the ill feeling of the average banker toward the Federal Reserve Bank than any other provision of the Federal Reserve Act."

Mr. J. H. Puelicher, Chairman of the Federal Reserve Membership Committee of the American Bankers' Association, reported at the 1920 convention of that association that it had become increasingly difficult to persuade eligible banks and trust companies to join the system because of the increasing hostility to the methods used by the federal reserve banks in promoting their program for par collection of checks. He asked that the committee be discharged since it could accomplish little more. This was done.[38]

An example of how the movement for par collection was regarded in some sections is provided in the following statement of Mr. G. G. Spier, Banking Commissioner of Kentucky, before the House Committee on Currency and Banking at Washington:[39]

"For the last two or three years the fur of Kentucky bankers has been rubbed in the wrong direction, not by members of Congress or the Senate of the United States, but by this Federal Reserve Board. In my opinion the state banks of this country

[37] Cousins, Marshall, *Desirability of State Bank Membership*, p. 17.

[38] 46 Proceed. A. B. A., 1920, *Journal A. B. A.*, Nov., 1920, p. 284.

[39] Hearings before the House Committee on Currency and Banking on H. R. 12379, May, 1920, p. 77.

are to-day fighting for their very existence, and they are going to make the best fight they can. They are not going to give up without a struggle. . . . In my opinion, it is the purpose of the Federal Reserve Board to bring into the system those that are eligible and to drive out of business those that are not eligible."

Mr. Pierre Jay, federal reserve agent at New York, said in 1922 that there were two main reasons why the state institutions did not join in greater numbers. They were: [40]

"1. The belief that membership in the system involves burdens or expense disproportionate to the advantages received in return, some of which, such as the avoidance of the old-fashioned money panic and the stabilization of banking conditions, they enjoy without membership. The fact that the Federal Reserve Banks do not pay interest on deposits whereas their city correspondents and reserve agents do pay interest on deposits is one of the apparent expenses which they fear to assume.

"2. Opposition to the plan of par check collection which the system has established and developed."

The Federal Reserve Board maintained that it was simply trying to enforce what it believed to be the correct interpretation of sections 13 and 16 of the Federal Reserve Act. It denied that it was endeavoring to drive the state institutions out of existence.[41]

Although compulsion has long since been abandoned the state banks have not forgotten the episode. Withdrawals from the par list have brought the number of non-

[40] Jay, Pierre, "State Banks and Par Collections," *The Annals*, January, 1922, p. 81.

[41] That the Federal Reserve Board has in general tried to avoid arousing unnecessary antagonism on the part of the state institutions is shown by a decision of the Board on June 25, 1918, refusing to approve of a law providing for the guaranty of national bank deposits. Among the reasons given by the Board for this attitude were that it would tend to stimulate competition and antagonism between the state and national banks, it would embarrass state banks which have too small a capital or have obligations preventing them from joining the national system, it would produce agitation in the states for a similar law and would destroy the harmony that has been growing up between the state and federal systems and officials. Furthermore there was no evidence that there were any great sums of money in hiding that such a law would bring out. Fed. Res. Bull., July 1, 1918, pp. 595-596.

remitting banks to 4,000. But as a sound objection to membership a desire to make exchange charges has little weight. For 85 per cent of all banks still remit at par. Membership would now make little difference in this respect.

IV

A number of objections are directed against the way in which the federal reserve system is administered rather than against specific provisions of the Act itself. Mr. Eugene Meyer, at that time Managing Director of the War Finance Corporation, stated in 1923 that he believed the hesitancy of most state institutions was due to dissatisfaction with the administration of the system, and not to provisions of the Federal Reserve Act.[42]

Specific objections of this nature have to do with the following questions:

a. It is claimed that membership still involves too much red tape in the securing of loans and rediscounts, that the required reports are burdensome, and that examinations are made in such a way as to cause additional labor and expenses. Such contentions, however, have little validity. They are made frequently because of ignorance or misunderstanding. With regard to examinations the policy of the federal reserve banks has been to coöperate as far as possible with the state banking authorities. There has been and still is some jealousy between state and federal examiners. But in many cases the federal reserve banks accept the examinations of the state officials in place of federal examinations. Independent examinations are made when the bank first applies for membership, and in case the soundness of the bank becomes a matter for question. But in general, objections of this description have little justification.

[42] Hearings before the House Committee on Banking and Currency on Bills S. 4280 (H. R. 13033), pp. 42–43, 54–56.

One phase of the examination question deserves attention. A number of state banks have become hostile to the system because their applications for admission have been rejected because of unsound condition. Many applications were rejected during 1920 and 1921 for this reason, the Dallas bank alone in 1920 refusing membership to twenty banks. Many rejections have occurred in the Chicago, Minneapolis, and St. Louis districts. Negative action on so many applications kept a number of banks from attempting to enroll, as they did not desire to run the risk of being turned down. To the contention that the standards of admission are too strict it must be replied that the system as a whole would have been in a stronger position during the past six years had requirements been even higher. There have been entirely too many failures among both national and state bank members. If anything, supervision must have been too lenient. Hostility to the system on the ground of strictness in examinations is absolutely unjustified. Banking standards in this country at present depend upon the administration of the federal reserve system. The large number of failures among members since 1920, approximately 900, gives rise to the feeling that more efficient supervision is highly desirable. The federal reserve system simply cannot afford to let down the bars further.

b. Some state bankers assert that they dislike the type of governmental supervision to which they would be subject. Government and federal reserve bank officials, they contend, are autocratic, and the Federal Reserve Board at times assumes a dictatorial attitude. Mention is made of the dangers of political influence. Finally, the state bankers argue that they would be subject to two masters, the state and federal authorities, the result being a duplication of supervision with a consequent increase in labor and expense to the member bank.

Much of this criticism is due to the methods used by the federal reserve banks to enforce par remittance on

checks. Fortunately, coercive methods have long since been abandoned, but much of the bitterness created still remains. It will take time to eradicate this feeling.

Unfortunately, certain officers of the federal reserve banks have not been as diplomatic at times as might be desired. Some of them, undoubtedly, have occasionally shown impatience with the state institutions. But such officers are in the minority. The majority of the reserve bank officials have spared no effort to conciliate the state institutions, and persuade them to join.

Some feeling has been engendered because of the failure to permit state bank members to be used as government depositories. There seems to be no valid reason why the state institutions should not be given this distinction except a rather doubtful interpretation of the law. Such discrimination seems to be unjustifiable and unfair.[43]

The investigation by the Joint Congressional Committee of Inquiry into Federal Reserve Membership reveals that many state bankers are somewhat afraid of the power of the federal reserve banks. They believe that the reserve banks are not particularly well disposed toward the state institutions, and accordingly express a hesitancy about putting themselves under their authority.[44]

Fear of political influence in the administration of the federal reserve system still exists. Unfortunately, there is basis for this fear in the way in which appointments were made to the Federal Reserve Board during the administration of President Harding. The failure to reappoint Gov-

[43] This was the position taken by J. S. Fisher, Pennsylvania Banking Commissioner, *Trust Companies Magazine,* May, 1920, p. 507. Early in 1928 the law was amended to remove this discrimination. *Fed. Res. Bull.,* June, 1928, p. 426.

[44] A banker's publication in 1922 expressed this sentiment as follows: "When the Federal government issued an appeal urging state banks to join the Federal reserve system, a hearty response was given and this coöperation enabled the government to centralize the banking power of the country. Others would become members of the Federal reserve system except for arbitrary methods employed by the Federal Reserve Board and the Federal reserve banks." *Journal A. B. A.,* Feb., 1922, p. 581.

ernor Harding is an example. As a whole, however, the system has been kept remarkably free from politics. There is little cause to decline membership for this reason.

The violent attacks upon the federal reserve system for the part it was accused of playing in bringing about the agricultural depression have not made state banks more favorably disposed to enroll. Many sections of the country still believe that the Federal Reserve Board deliberately deflated the farmer. In spite of the fact that such accusations have long ago been shown to have no foundation there is still considerable sentiment in some localities against the system for this reason.

c. Some state bankers maintain that the federal reserve banks are administered mainly for the national banks, and that the regulations are drawn up to cover the type of business done by national banks. To refute this argument it seems hardly necessary to reiterate that state bank members enjoy more freedom in many respects than do the national banks. National banks cannot withdraw without surrendering their charters, while state members may withdraw at will. The national banks are under greater restrictions regarding loans, reports, examinations, operations, and administration than are the state bank and trust company members. In fact there is much more of justice in the contention of the national banks that it is the member state institutions which have been unduly favored. It is this feeling that is partly responsible for the branch banking controversy. National banks feel that they are suffering greatly from the competition of the state institutions. The undesirability of a national charter is so great from the standpoint of individual banks that many of them have converted into state institutions. This is one reason for the decline in the number of national banks. Since the national banks always have been and always will be the backbone of the federal reserve system the member state institutions cannot and should not be shown any favoritism. But, at present, the law does favor them.

d. Another objection that is commonly heard is that the federal reserve banks should give immediate credit for checks received from members of the clearing system. "Deferred availability" is not specifically provided for in the act. At one time immediate credit was given but it was abolished because of its obvious inadvisability. The regulations of the Board, and not the law, are responsible for the introduction of "deferred availability". One of the grounds upon which the last par collection suit against the Federal Reserve Bank of Atlanta was argued was upon this very question. The Supreme Court of the United States decided that "deferred availability" for members was justifiable under the law. It means of course that "float" cannot count as reserve for members as it may still do under various state laws. While many state banks feel that this restriction renders membership undesirable for them, yet this is no reason for permitting immediate credit. "Float" never was and never will be a real bank reserve under sound banking practice.

e. The open market operations have come in for criticism. Many members feel that when the federal reserve banks buy and sell in the open market they are competing with the members. There is a large measure of truth in this contention. While open market policy may not be as definitely developed as might be desired, yet such operations must be a part of any sound method of discount rate control. Effective regulation of rates cannot be secured otherwise. If the reserve banks paid interest on reserves as many banks desire they would be compelled to enter the market much more intensively than now. The reserve banks must at times engage in this business if they are to show a sufficient profit to pay expenses and dividends. It is exceedingly doubtful whether open market transactions have injured members sufficiently to give any real basis for complaint.

f. The policy of the Federal Reserve Board toward branch banking within the federal reserve system has caused

strong objection and a controversy has developed which bids fair to have consequences of great importance in the future development of the federal reserve system. This controversy is discussed in Chapter XV on "State Banks and Branch Banking in the Federal Reserve System".

V

There is still some dissatisfaction regarding the loan provisions in section 9 of the Federal Reserve Act. The original Act prescribed that the restrictions on loans by national banks applied to member state institutions. This prevented a member from lending to any one person, firm, or corporation, an amount in excess of 10 per cent of the lending bank's capital and surplus. This aroused so much opposition that the amendments of June 21, 1917, changed section 9 so that no restriction rested on the amount which a member state institution might lend, but it could not rediscount with the federal reserve bank "notes, drafts, or bills of exchange of any one *borrower* who is liable for borrowed money to such state bank or trust company in an amount greater than ten percentum of the capital and surplus of such state bank or trust company". The meaning of this amendment was not quite clear, so the Federal Reserve Board was called upon a number of times for interpretations. First, it was made clear that where the loans to any one person, firm, or corporation exceeded 10 per cent of the capital and surplus of the bank *no* notes, drafts, or bills, *whatever* bearing the signature of that person, firm, or corporation as borrower could be rediscounted. [45] The state institutions requested an amendment whereby they might be permitted to rediscount some of such a customers' paper. Certain opinions of the Counsel of the Board modified the severity of the law considerably. For example, on June 21, 1918, he stated that where a member state institution had loaned to one of its customers an amount equal to 30

[45] *Fed. Res. Bull.*, Sept. 1, 1917, p. 697–698.

per cent of its capital and surplus, and had rediscounted two-thirds of this with a correspondent bank, the other one-third was eligible for rediscount at the federal reserve banks. For he said, the two-thirds were no longer owned by the lending bank, but by the correspondent, so the borrower was, strictly speaking, liable to the correspondent for two-thirds and to the member institution involved for only one-third. While, he admitted, the member institution applying for rediscount was contingently liable if the borrower failed to pay, this did not make that bank owner of the notes and bills from a legal viewpoint.[46] This alleviated the situation to some extent. State bank and trust company members were thus given a great advantage over national bank members in this respect.

Another clause of section 9 moderated the severity of the restriction on loans. It read as follows: "The discount of bills of exchange drawn against actually existing values and the discount of commercial or business paper actually owned by the person negotiating the same shall not be considered as borrowed money within the meaning of this section." The Counsel of the Board gave an opinion explaining this clause. If A, he said, borrowed from a member state bank 10 per cent of its capital and surplus on straight loans, 15 per cent additional on commercial or business paper actually owned by him, and 20 per cent more on bills of exchange drawn against actually existing values, then under the terms of the law A was liable for borrowed money only to the extent of 10 per cent of the bank's capital and surplus and the bank might rediscount this paper at the federal reserve bank. But had the straight loans exceeded 10 per cent the federal reserve bank could not have rediscounted any paper of that customer whatsoever, whether straight loans, bills of exchange drawn against actually existing values or commercial or business paper actually owned by him.[47] The Board has defined bills of

[46] *Ibid.*, July 1, 1918, p. 638.
[47] *Fed. Res. Bull.*, Dec. 1, 1919, p. 1157.

exchange drawn against actually existing values as "drafts or bills of exchange secured by shipping documents conveying or securing title to goods shipped".[48]

But even after these changes there was some dissatisfaction over the 10 per cent restriction. An amendment to sections 5200 and 5202, United States Revised Statutes, approved October 22, 1919, gave the national banks power to lend in certain cases more than the 10 per cent limit. The amounts which a national bank might lend to any one person, firm, company, or corporation under section 5200 as amended are: [49]

CHARACTER OF LOANS	AMOUNTS LOANABLE
(A) Accommodation or straight loans, whether or not single name.	Maximum limit 10 per cent of bank's paid-up and unimpaired capital and surplus.
(B) "Bills of exchange drawn in good faith against actually existing values." The law expressly provides that this phrase shall also include: (a) Drafts and bills of exchange secured by shipping documents conveying or securing title to goods shipped. (b) Demand obligations, when secured by documents covering commodities in actual process of shipment. (c) Bankers acceptances of the kinds described in section 13 of the Federal Reserve Act.	No limit imposed by law.

[48] *Fed. Res. Bull.*, August, 1922, pp. 932–934. For complete statement of the Board's interpretation of "actually existing values" see *Fed. Res. Bull.*, Nov., 1922, pp. 1286–1287.

[49] *Fed. Res. Bull.*, Nov. 1, 1919, p. 1055. This compilation was republished with approval in *Ibid.*, August, 1922, p. 934.

(C) Commercial or business paper (of other makers) actually owned by the person, company, corporation, or firm negotiating the same.	No limit imposed by law.
(D) Notes secured by shipping documents, warehouse receipts, or other such documents conveying, or securing title covering readily marketable nonperishable staples, including live stock. No bank may make any loan under (D), however, (a) Unless the actual market value of the property securing the obligation is not at any time less than 115 per cent of the face amount of the note; and (b) Unless the property is fully covered by insurance and in no event shall the privilege afforded by (D) be exercised for any one customer for more than 6 months in any consecutive 12 months.	15 per cent of bank's capital and surplus, in addition to the amount allowed under (A); or if the full amount allowed under (A) is not loaned then the amount which may be loaned in the manner described under (D) is increased by the loanable amount not used under (A). In other words, the amount loaned under (A) must never be more than 10 per cent, but the aggregate of (A) and (D) may equal, but not exceed 25 per cent.
(E) Notes secured by not less than a like face amount of bonds or notes of the United States issued since April 24, 1917, or by certificates of indebtedness of the United States.	10 per cent of bank's capital and surplus, in addition to the amount allowed under (A); or if the full amount allowed under (A) is not loaned, then the amount which may be loaned in the manner described under (E) is increased by the loanable amount not used under (A). In other words, the amount loaned under (A) must never be more than 10 per cent but the aggregate of (A) and (E) may equal, but not exceed 20 per cent.

Some examples of what a national bank may lend at any one time to any one customer, expressed in terms of percentage of the bank's capital and surplus are:

	ILLUSTRATION 1	ILLUSTRATION 2	ILLUSTRATION 3
	Per cent	Per cent	Per cent
(A) Accommodation or straight loans..	10	5	5
(D) Notes secured by warehouse receipts, etc.	15	20	15
(E) Notes secured by a like face amount of U. S. Government obligations	10	10	15
Total	35	35	35

(B) Bills of exchange drawn against actually existing value.........No limit imposed by law.
(C) Commercial or business paper.....No limit imposed by law.

A number of member state institutions claimed that now national banks had an advantage over them on loans outlined in section D of the preceding summary, and requested to be put upon the same footing. So on July 1, 1922, the following amendment to paragraph 10, section 9 of the Federal Reserve Act was approved: [50]

"That no Federal reserve bank shall be permitted to discount for any State bank or trust company notes, drafts, or bills of exchange of any one borrower who is liable for borrowed money to such State bank or trust company in an amount greater than that which could be borrowed lawfully from such State bank or trust company were it a national banking association." This amendment puts national and state member banks on a basis of equality with regard to rediscounts.

But since *no* notes, drafts, or bills of exchange of any one borrower who is liable for borrowed money in excess of these limits can be rediscounted, many state banks claim that, in effect, this restriction will prevent them from lend-

[50] *Fed. Res. Bull.*, August, 1922, pp. 932–934 contains interpretations of the meaning of this amendment.

ing, at certain periods, more than 10 per cent of their capital and surplus to any one person. Many banks in farming communities claim that they must exceed this limit, and that it would be very disadvantageous to become a member for that reason. It is difficult to see any soundness in this objection because, as we have seen, if the excess over 10 is rediscounted elsewhere with a correspondent bank, then the 10 per cent will be taken by the federal reserve bank. It is impossible to see why a bank would be any worse off in the system than outside of it in this matter. Many banks would be able to carry their excess loans by rediscounting with the federal reserve bank paper of a borrower who had not exceeded the 10 per cent limit.

State member banks and trust companies cannot rightly complain about the loan provisions of the Federal Reserve Act. These banks have been treated with much greater leniency than the national banks. National banks could until recently lend comparatively little on real estate. State members have no restriction in this respect; all they must do is to refrain from lending so much on real estate that their liquidity is impaired. No definite limit is set as in the case of national banks.

A national bank may not lend more than 10 per cent of its capital and surplus to any one person, firm, or corporation. A member state institution is free from this restriction, except that where it exceeds the limit no paper of that borrower may be rediscounted, but the interpretation of the counsel of the Board has practically nullified that limitation.

It has been argued that members should be permitted to borrow on high grade municipal and public utility bonds. Charles A. Hinsch, a former president of the American Bankers' Association, stated in 1917 that probably the only thing lacking to bring in the state banks after the amendments of June 21, 1917, was the granting of permission to borrow from the reserve banks on high grade municipal

and public utility bonds.[51] Senator Calder, of New York, sponsored a bill (Senate N. 2908) to authorize the federal reserve banks to lend to member banks upon certain classes of securities as collateral. The Trust Company Section of the American Bankers' Association in 1917 adopted resolutions approving it, and requested the General Convention of the Association to do likewise.[52] The convention refused to do so.

A questionnaire was sent out in 1922 by the State Bank Section of the American Bankers' Association asking the bankers whether they desired to be allowed to rediscount farm mortgages with the federal reserve banks and the answers were mainly in the affirmative.[53]

Certain of the savings banks were very active in endeavoring to secure an amendment of this nature, as many of them are prevented by state laws from investing in paper of the type eligible for rediscount. But these efforts met with failure, and rightly so, for such a provision would go far towards impairing the liquidity of assets which must at all times be maintained by the federal reserve system. If the federal reserve banks were to absorb any considerable amount of such securities it would not only greatly impair their ability to render aid in emergency, but would increase the likelihood of another period of inflation. It has been enough of an evil to permit lending on government securities, without adding the harmful practice of lending on other classes of securities. The investments of the federal reserve system must in general be restricted to short time self-liquidating paper. We have seen what harm results from any practice which may create large amounts of "frozen credit."

[51] 43 A. B. A., 1917, p. 705.
[52] *Journal A. B. A.*, Oct., 1917, p. 285.
[53] *Journal A. B. A.*, April, 1922, p. 693.

Summary

In the foregoing chapter the following objections to membership have been mentioned and discussed:[54]

1. Membership is not necessary because all the advantages of the system are received through city correspondents.

[54] The dissatisfaction felt by a number of members is well expressed in the following letter from the Peoples' Bank of Cambridge, Idaho: "As to whether the membership in the Federal Reserve System has been profitable to us in the time we have joined beg to state that we cannot figure how it has unless one can figure that it has been worth about $2,000 to us on account of stabilizing the banking system during the past year. We have been compelled to keep about $35,000 during the past year with the Reserve Bank upon which we could have been drawing 3% from our correspondent, also we have been out about $3 to $4 per day in exchange we used to charge on outside checks. When our account with the Federal Reserve Bank gets below reserve on account of checks that are cleared there which we have no knowledge of till received here we are charged 7 to 8% on the amount. We think we should be given time to make the deficiency good before the interest charge is stuck on, especially as we are paid no interest on the big balance we must keep with them, and as they are making a large profit.

"In reference to rediscounts we have not been obliged to turn any of our paper for some time and have not benefited from the lower rate which we might have received, however our correspondents are very glad to take notes for us that the Federal Reserve Bank will not touch. We sent in a note for several thousand dollars to them and though the party's assets showed about $40,000 above his liabilities they returned it to us on account of his quick assets not being within a few dollars of what they thought they should have been. This was during the war when we had worked hard to sell bonds here, thereby draining the country here of money. This is a farming country here and we have to loan the farmers, of course, on their crops, but we are informed that the Federal Reserve Bank does not figure crops but little account in a man's statement. We could not do business in this country if we had to depend on the Federal Reserve Bank to take care of us."

Yet another Idaho bank, the Farmers Commercial and Savings Bank, capital $25,000, of Oakley related its experience as being of a different nature in these words: "Replying to yours of the 19th, relative to the advantage we obtain belonging to the Federal Reserve System, will say we find it tends to a broader outlet to a re-discount paper, also it acts as a medium in a way of good advertising, especially to those who lack confidence in our Banking System as they feel the Government is behind the Reserve System, and relieves all doubt in their minds as to the stability of a Bank of this Character. It also affords less interest to us in the way of discount as against our correspondent bank. Taking it as a whole we feel that it has been a great advantage to us to belong to this system." (Fed. Res. Bank of San Francisco. State Bank Membership etc., Letters 10, and 24).

City correspondents take care of all the needs of the nonmember country banks and urge them not to join.

2. Non-payment of interest on reserves deposited with the federal reserve banks makes membership unprofitable for many banks, since "float" cannot count as reserve for members, and nonmembers because of stability given by the system carry much smaller cash reserves than formerly. A number of states still have no law permitting state members to substitute federal reserve for state requirements.
3. The hostility which arose because of the attempt to enforce par remittance on checks returned for payment by federal reserve banks.
4. Objections which have been made to administration of system:
   a. Red tape, reports, and examinations.
   b. Dictatorial control by Federal Reserve Board and government officials. Political influence. Too much government in business.
   c. System administered only for national banks.
   d. "Deferred availability" on checks sent to federal reserve banks for collection.
   e. Open market operations.
   f. Branch banking policy of Federal Reserve Board.
5. Restrictions on loans and rediscounts for member state institutions are too burdensome.

A review of the foregoing objections makes it clear that any bank which is doubtful about joining the system can find excuses sufficient to remain outside. There is no doubt that many banks can show larger profits as nonmembers than as members. This is especially true of those nonmember banks which have decreased the amount of cash carried on hand. The fact that their city correspondents can care for all of their needs, that interest is not paid on reserves deposited with the federal reserve banks while city correspondents pay from 2 to 3 per cent on such re-

serves, that under the laws of many states "float" may still count as reserve, and that there is a general dislike and distrust of the methods of administration furnish the chief reasons why the majority of state banks and trust companies will never enter the federal reserve system. Whether any amendments to encourage larger membership are desirable will be discussed in the concluding chapter of this volume.

CHAPTER XIII

THE PAR COLLECTION CONTROVERSY

Of all the problems with which the Federal Reserve Board has had to contend probably none presented more difficulty than those which arose in the attempt to establish a nation-wide par collection system. Beneficial as universal par collection of checks would be to the business interests of this country it has met with most determined opposition on the part of many bankers. The controversy between the advocates of par collection and those opposing it has been one of the bitterest in all the banking history of the United States. It has led to considerable litigation in the courts. Four decisions of the United States Supreme Court already have been rendered, and there is a probability that another such decision will be necessary if the Federal Reserve Act is so amended as to place definitely upon the federal reserve banks the obligation of compelling every bank in the country to remit to the federal reserve banks at par. All the member banks of the federal reserve system have remitted to the federal reserve banks at par since July, 1916. The high point in the number of nonmember banks so remitting was reached November 15, 1920, at which time 19,188 nonmembers were remitting at par.[1] On January 15, 1921, only 1,705 banks in the entire country still refused to remit at par.[2] Since that date a large number of nonmember banks have withdrawn from the par list, so that at the present time, there are approximately 4,000 banks which do not remit at par.

There is still some misunderstanding as to what is

[1] *Fed. Res. Bull.*, Dec., 1920, p. 1492.
[2] *Ibid.*, Feb., 1921, p. 247

meant by "par collection of checks". Although the term "par clearance" is frequently used, probably "par remittance" would be better terminology, as the federal reserve banks do not actually clear checks and the present controversy has to do with methods of remittance. But the expression "par collection" seems now to be the one most widely used, so in order to accord with popular usage "par collection" is the term adopted by the present writer. The following example will explain what the term "par collection" signifies, and why so much opposition arose to the activities of the federal reserve banks in this respect.

Suppose that in the days before the establishment of the federal reserve system a bank depositor in Wisconsin drew a check for $100 on his bank and sent it to a Chicago merchant in payment for some purchases. The Chicago merchant deposited the check in a Chicago bank. If the Chicago bank returned the check directly to the Wisconsin bank for payment the Wisconsin bank would remit with a draft on its Chicago correspondent, not for the full amount of $100 however, but probably for $99.90. This deduction of ten cents was called an exchange charge. Another way in which the check might have been handled was that through the Chicago clearing house the check eventually came into the possession of the Chicago bank which was the correspondent of the Wisconsin bank upon which the check was drawn. This Chicago correspondent returned the check to the Wisconsin bank, possibly charging the account of the Wisconsin bank $100. But the Wisconsin bank, instead of permitting its account to be charged the full $100 might have had an agreement with its Chicago correspondent whereby the account would not be charged but the checks would be returned to the Wisconsin bank for payment. Thereupon, the Wisconsin bank would remit only $99.90. This remittance, frequently, was in the form of a draft upon the account of the Wisconsin bank in the Chicago correspondent itself. Competition for country

bank accounts led many large city banks to make such an agreement.[3]

Although the Wisconsin bank remitted only $99.90 the account of its depositor was charged the full $100, thereby giving the bank a profit on the transaction. In order, however for this profit to be realized it was necessary for the Wisconsin bank to have an agreement with its Chicago correspondent that checks on other banks received by the Wisconsin bank and sent to the Chicago bank for collection should be credited in full to the account of the Wisconsin bank. The Wisconsin bank was, then, able to collect at par on all other banks but refused to remit at par for its own checks. The arrangement was profitable for the Wisconsin bank in spite of the fact that it had to maintain a large account with the Chicago bank as a compensation for the service. On this account the Wisconsin bank received from 2 to 2½ per cent interest performed.

Upon whom did the ten cent deduction made by the Wisconsin bank fall ultimately? Sometimes the Chicago correspondent assumed it. Sometimes it was passed on to the Chicago merchant depositing the check in which case he was given credit for only $99.90, unless perhaps he maintained such a large balance with his Chicago bank that the bank desiring his goodwill assumed the loss itself. Where the loss fell upon the Chicago merchant it became a part of his cost and was shifted wherever possible to the consuming public in the form of higher prices. It is this shifting of exchange charges to the public in the form of higher prices which is assumed whenever reference is made to the burden placed upon commerce and industry by exchange charges. The practice of making such charges was a relic of the days when considerable expense was involved in the transfer of currency to meet checks returned by other banks for payment. Banks which did not make

[3] Some of the material in this chapter is adapted from Tippetts, C. S., "The Par Remittance Controversy," *American Economic Review*, December, 1924, pp. 629–648.

such a deduction, but sent the full $100 in remitting for checks drawn upon them and returned for payment were said to practice "par remittance."

The foregoing example, describing the relations existing between the Wisconsin bank and its Chicago correspondent, is typical of banking practice in many parts of the United States before the development of the federal reserve system. In order to understand why controversy arose over the continuance of the practice of making deductions in remitting for checks it must be borne in mind that the development of a check collection system by the federal reserve banks has gradually resulted in the displacement of the Chicago correspondent as a check collection agency by the Federal Reserve Bank of Chicago. Had the federal reserve banks been permitted by law to allow the deduction of exchange charges on checks returned to drawee banks for payment the controversy over par remittance might not have arisen. The federal reserve banks could not, however, have assumed the burden of the charges, for the total would have been enormous. It would have been necessary for the charges to have been passed on to the banks depositing the checks in the federal reserve banks. But, since the Hardwick Amendment of June 21, 1917, to the Federal Reserve Act, all checks received by the federal reserve banks must be collected at par without deduction. It was the attempt of the federal reserve banks to increase their activities until they became collecting agencies for practically all out-of-town checks, whether drawn on a member or a nonmember bank, thereby wiping out in wholesale manner the chance to make deductions for exchange, that brought the par remittance controversy to a head. The earnings from such exchange charges constituted a large portion of the profits of many banks, and these banks, especially the banks which were not members of the federal reserve system, fought vigorously to retain this source of income.

But former Governor Harding believes profits from exchange charging have been much exaggerated.[4]

The system in vogue before the establishment of the federal reserve banks was the source of a number of evils. One of these was that country banks could, under most state laws, count the full amount of checks sent to their city correspondents as being on deposit in the city banks the moment the checks were placed in the mails. While no interest was paid upon this part of the deposits until the checks were actually collected, yet the checks in transit (commonly known as "float") could under the laws of many states be counted as legal reserve. "Float" could be counted as reserve by national banks also before 1914. A large proportion of the country's total banking reserves was made up of checks in process of collection. A part of the "float" was always made up of checks which were later returned unpaid. Yet these same checks had for days been included among the legal reserves against deposits. Unfortunately, "float" may still be counted as reserve by many nonmember state banks. Under the system of "deferred availability" now practiced by the reserve banks member banks are denied this privilege.

Another evil was the circuitous routing of checks to avoid exchange charges of the nature previously described. In a pamphlet "Of Service to Banks and Business," circulated by the federal reserve banks, the long travels of one check are described. A check drawn on a bank in North Birmingham, Alabama, was deposited in a Birmingham bank. The Birmingham bank, to avoid the payment of exchange, sent the check to a bank 488 miles away in Jacksonville, Florida. The Jacksonville bank, for the same reason, sent the check to Philadelphia, from whence it journeyed back to Birmingham. In this time the check traveled 2,250 miles and was a week in so doing. But this does not tell the entire story, for this particular check, not

[4] Harding, W. P. G., The Formative Period of the Federal Reserve System, pp. 50, 56.

being good, was required to retrace its steps through the Philadelphia and Jacksonville banks before it finally was returned to the original depositor. It was in transit fourteen days and traveled 4,500 miles, and all because a bank in North Birmingham would have deducted exchange upon it. This bad check was, furthermore, probably listed as legal reserve a number of times.

The main steps in the development of the federal reserve collection system will now be outlined. When the bill creating the federal reserve system was still in Congress many bankers objected vigorously to those sections of it which might lead to the elimination of exchange charges by members. Many objections were raised in the hearings on the bill before the Senate committee on Banking and Currency.[5] The currency commission of the American Bankers' Association recommended that section 16 be so amended as to permit the continuance of the practice of charging exchange.[6] But feeling was so wide-spread that exchange charges were undesirable that the bankers were unsuccessful in their attempts to force an amendment. It should not be assumed that all bankers opposed the elimination of exchange charges. Many banks, particularly in New England, had remitted in full for years before 1914. The most vigorous opposition came from the small country banks.

Sections 13 and 16 of the Federal Reserve Act contained provisions which laid the foundation for a clearing and collecting system operating through the federal reserve banks. It was realized that it would be impossible to effect so revolutionary a change in banking methods at once, and so these provisions were for the most part made per-

[5] For examples of this criticism see Hearings on Glass-Owen Bill before Senate committees on *Banking and Currency*, Vol. I, p. 198–9, 192–9; Vol. II, pp. 1264–1271, 1582, 1598, and 1640; Vol. III, pp. 2195, 2215 and 2308. Among those protesting were Mr. George M. Reynolds and Mr. James B. Forgan who stated that serious losses would accrue to many national banks were exchange charges forbidden.

[6] *Ibid.*, Vol. I, p. 15.

missive rather than compulsory. Section 13 *permitted* the federal reserve banks to receive *on deposit* checks and drafts drawn upon *solvent member banks* if these checks and drafts were payable upon presentation. The federal reserve banks might also receive, *for exchange purposes only,* checks and drafts drawn upon *solvent member banks* or other federal reserve banks if these checks and drafts were payable upon presentation. Section 16 *required* each federal reserve bank to receive on deposit *at par* from *member banks* or from other federal reserve banks checks and drafts drawn upon any of its depositors. The same stipulation was made with regard to remittances from another federal reserve bank of checks and drafts drawn by any depositor in another federal reserve bank or member bank. But it was definitely stated that no prohibition was placed upon the right of a member bank to charge for the actual expense incurred in collecting and remitting funds, or for exchange sold to their patrons. The Federal Reserve Board, however, was instructed to fix the charges made by members against their customers whose checks were cleared through the federal reserve banks. The law assumed that the federal reserve banks might find it necessary to charge for the collection services, for the Federal Reserve Board was given the power to fix the charges which might be made by federal reserve banks for clearing and collecting checks. Furthermore, the Board was given the power, "at its discretion" to act as a clearing house for the federal reserve banks, and it might, should it so desire, require each federal reserve bank to act as a clearing house for its member banks.

The Federal Reserve Board, realizing that it was facing one of the most difficult problems involved in the formation of the federal reserve system moved very cautiously in taking advantage of the powers conferred in the act.[7] It was realized that the problem was complicated and that a change would affect fundamentally the entire reserve

[7] 1 Fed. Res. Board, 1914, pp. 19–20.

structure of the banking system. Members were permitted to count their balances with correspondents as reserves for three years, but these balances had made it possible for the country banks to collect checks on out-of-town banks at par, while still deducting exchange in remitting for checks returned to them for payment. So, any change in the methods of charging exchange would have an affect upon the number and size of accounts maintained with city correspondents.

The first step toward eliminating exchange charges was taken in December, 1914, when the Federal Reserve Banks of St. Louis and Kansas City received permission from the Federal Reserve Board to establish a system requiring all member banks in those districts to remit at par on checks forwarded to them by their federal reserve banks. Boston had a similar system on a limited scale. After much study and investigation the Federal Reserve Board instituted a *voluntary* system of par remittance for all member banks in June, 1915. Thereupon the Federal Reserve Bank of St. Louis abolished its compulsory plan. Kansas City, however, retained its compulsory system. At this time the gold settlement fund was set up in Washington for the purpose of facilitating clearings between federal reserve banks. The plan making it optional with the member banks as to whether they would remit to the federal reserve banks at par proved to be a failure, only 25 per cent of the member banks agreeing so to remit. Checks upon those member banks which refused to remit at par under this plan were not handled by the federal reserve banks. Those member banks which wished to charge exchange still did so, while they collected on the banks which would remit at par through the system.

Although the members in the voluntary system remitted at par, they could collect only a small part of their checks at par. So the voluntary system was unfair to them. The various federal reserve agents in their 1915 reports

practically all agreed that the reason so few members joined the voluntary system was because of the loss of exchange and profits involved.

It was soon realized that a voluntary scheme would not be satisfactory and that compulsion was necessary to put an effective par collection system into effect. The Federal Reserve Board believed that the failure of the voluntary scheme was partly due to the inability of merchants and jobbers to realize the advantages of par collection and their failure to insist upon their own banks joining and co-operating in the plan. It also believed that the Federal Reserve Act did not intend to permit the member banks to continue to count deposits in other banks as reserves, and that it was the intent of the Act that the federal reserve banks should take over the check collection function being done at that time by correspondent banks.[8] Many conferences were held between the members of the Federal Reserve Board, the governors of the federal reserve banks, the federal reserve agents, and the transit managers of the reserve banks where the situation was discussed at great length. Finally it was decided to put into effect a compulsory plan affecting all members beginning June 15, 1916. Owing to the time necessary to complete all arrangements the inauguration was postponed until July 15. The compulsory plan went into effect in July, 1916, in the face of intense opposition on the part of the country national banks, many of whom threatened to retire from the federal reserve system and take out state charters because of the impending loss in exchange charges. These threats were not, however, carried into effect. Circulars were sent out by all the federal reserve banks to the member banks informing them that while they could still carry accounts with their present correspondents they must pay without deduction checks drawn on themselves and presented by the federal reserve banks at their own counters or sent by the

[8] 2 Fed. Res. Board, 1915, p. 16-17.

reserve banks through the mails to them. Nonmembers were not to be affected by this change.

It must be constantly borne in mind that the par collection controversy involves only remittances for checks which have come into the possession of the federal reserve banks and are returned by them to the drawee banks for payment. National and state banks can even now, as always, make exchange charges against each other. Some of them still do so. It is only on remittances to the federal reserve banks that such deductions cannot be made. Under the compulsory plan no member bank was *required* to send items to the federal reserve banks for collection, but it was required to remit at par for checks drawn upon it which came into the possession of the federal reserve banks and were returned by the reserve banks for payment. The compulsory plan laid the foundation for the collection of checks upon nonmember banks also, for while there was as yet no authority for permitting nonmembers to deposit checks in the federal reserve banks for collection, the member banks could send to the reserve banks for collection checks upon those nonmembers who would agree to remit at par to their district federal reserve bank.[9]

After par remittance was made compulsory for all member banks it was thought to be desirable to amend the law so as to give specific permission to the federal reserve banks to receive checks drawn upon nonmember banks. With this aim in view, the Federal Reserve Act was again amended September 7, 1916, by striking out the words in section 13 which had limited eligible checks to only those drawn upon "solvent member banks". This left as the only

[9] Circular No. 1, series of 1916, May 1, 1916, issued by the Board explained how the compulsory system was to work. Although not expressly so provided in the Act, the counsel of the Board stated that reserve banks, by implication, had power to collect checks drawn on nonmembers who would remit at par. This power was found in section 4 of the Act, which authorized the reserve banks to exercise such incidental powers as might be necessary to carry on the business of banking with the limitations prescribed by the Act. 7 Fed. Res. Board, 1920, p. 337.

requirement for checks eligible for receipt by the federal reserve banks that they should be "payable upon presentation". As a result of this change aproximately 8,000 nonmember banks had agreed to remit at par to the federal reserve banks by the end of 1916, making a total of approximately 15,000 banks so remitting on that date.[10] While the nonmember banks were not able, under the law as it then stood, to send checks directly to the federal reserve banks for collection, actually they were able to collect upon banks remitting at par for they sent their checks to correspondents who were member banks, and these correspondents deposited the checks in the federal reserve banks.

This expansion of the par collection system had taken place in the face of stubborn opposition. So long as the system was merely voluntary there was little organized objection but when it was announced that compulsion would be brought to bear on members the bankers affected were aroused to action. On May 8, 1916, the Executive Committee of the Clearing House Section of the American Bankers' Association adopted resolutions recommending the postponement of the inauguration of the compulsory plan. On June 10, a conference of bankers at St. Louis declared the proposed plan to be unsound and recommended the repeal of section 16. A number of the bankers at this conference met in Washington D. C. on July 11 and laid plans to enjoin the federal reserve banks from forcing member banks to remit at par, and to test the constitutionality of section 16.

The secretary of this bankers' conference issued a statement that the proposed suit was regarded by the Federal Reserve Board in an entirely friendly light. The Board,

[10] The Board had prophesied early in 1916 that the number of remitting banks would increase to 15,000 if this amendment was passed, for the following reason: "as any bank will be likely to lose desirable business when checks drawn upon a nearby competitor circulate at par, it is believed that in the near future checks upon practically all banks in the United States can be collected at par by the Federal Reserve Banks." 3 Fed. Res. Board, 1916, p. 10.

however, replied that this was not correct, because although any one was at perfect liberty to go to the courts and test out the law, yet "friendly" generally means that both parties are in doubt as to the power granted by the law, while the Board had no doubts whatsoever as to its power to extend the collection plan under the provisions of the Federal Reserve Act.[11]

But the Administrative Committee of the American Bankers' Association decided not to take part in any legal action to test the constitutionality of sections 13 and 16. It was decided, rather, to request Congress to amend these sections so as to eliminate the provisions for par collections and also those sections giving the Federal Reserve Board power to fix reasonable charges for the collection of checks.[12]

Bankers opposed to par collection met in Kansas City in September, 1916, while the annual convention of the American Bankers' Association was being held. A group of country bankers at this convention wished to test the constitutionality of sections 13 and 16. Sentiment at the convention was strongly opposed to par collection and a committee of twenty-five, composed of fifteen country bankers and ten reserve city bankers, was appointed to work out suitable amendments to the Federal Reserve Act to be recommended to Congress. It was decided not to inaugurate a lawsuit at that time.[13]

Governor Harding of the Federal Reserve Board was present at this convention. He stated that the attempt to amend the law was justifiable, and that the Federal Reserve Board would, of course, administer the law as amended by Congress if a change were made. President James K. Lynch of the Association, in his annual address, expressed his views as follows: "My sympathies are strongly with the country banker who is contemplating a loss of revenue

[11] *Fed. Res. Bull.*, Aug. 1, 1916, p. 374.
[12] *Journal A. B. A.*, July, 1916, p. 7.
[13] Report of Committee of Five, 47 *A. B. A.*, 1921, *Com. and Fin. Chron. Supp.*, Oct. 29, 1921, p. 124.

through the operation of this portion of the Reserve Act. To my mind, it is pointless to compare the removal of exchange charges to the removal of toll gates from the highway. The transfer of funds is a service which is as much entitled to compensation when made by a bank, as it is when made by an express company or by the postal official."[14]

The Federal Reserve Agents in their 1916 reports remarked upon the opposition which had arisen to par collection in their districts.[15] In the New England states many banks had remitted at par for years and the opposition was least in evidence there. In fact, the Federal Reserve Bank of Boston, having taken over the Boston Country Clearing House, was able to collect checks drawn upon any member or nonmember bank in New England almost immediately after the inauguration of the new plan. New York and Philadelphia reported that many banks were going voluntarily on the par list. The Federal Reserve Board observed that the force of competition with member banks was driving many nonmembers on the par list.[16] The Board further stated that the purpose of the 1916 amendments had not been to benefit the nonmembers particularly, but to obtain for the country the benefits of a universal par collection system. A system of this kind to be highly effective must include all checks on all the banks in the country. This latter view was held by the Federal Advisory Council also, for in 1916 this body stated that the system could not be economically effective until the federal reserve banks could collect on nonmembers as well as members, and that to be successful a system must be universal.[17]

The federal reserve banks at first made a small charge for collecting checks. This charge was one and one-half cents an item except in the Dallas and San Francisco dis-

[14] *Journal A. B. A.*, Oct., 1916, p. 295.
[15] 3 Fed. Res. Board, 1916, p. 298, 317, 435.
[16] *Ibid.*, p. 28.
[17] 5 Fed. Res. Board, 1918, p. 793.

tricts where two cents was charged on certain items payable at distant points. A number of member banks claimed that this was an expense to them because their correspondents would collect for them for nothing. So they could not use the system for collecting their out-of-town checks, while they must remit at par for checks drawn on them. On the other hand, in spite of this charge many banks found that collection in full on the checks they sent in was a great saving to them. At the end of 1917 the reserve banks were charging the member banks a service charge of from $\frac{9}{10}$ of 1 per cent to one and one-half cents per item to cover postage, stationery, accounting, and other expenses. When we recall the difficulty the reserve banks had in earning dividends during the first three years it is hard to see how this charge could have been avoided. But early in 1918 some reserve banks began to collect the first 500 checks free daily and only charged on the number above that amount. On July 1, 1918, the charge disappeared entirely and from that date the federal reserve banks collected without charge all checks on banks on the par list.[18]

All banks, however, were not opposed to the compulsory collection plan. Many were heartily in favor of it, generally the larger banks which had not been in the habit of making such charges themselves. Many of them found that par collection of out-cf-town checks resulted in considerable saving to them. It will be remembered that in the study of the experiences of the first banks to join an almost equal difference of opinion was found as to whether this plan resulted in a profit or a loss.[19] The Federal Reserve Bulletin of November 1, 1916, published a letter from a small country bank relating how great an advantage the collection plan had been, also that a number of accounts held in other banks merely for the purposes of collection had been closed out, that items could now be collected

[18] 5 Fed. Res. Board, 1918, pp. 76–77.
[19] See Chapter V of this volume.

more quickly and that money, labor, and time were being saved.[20] It should be added, however, that this bank stated it had never made any considerable profit from exchange charges. The National Association of Credit Men also came to the support of par collection. In a letter to all its members it stated that the advantages already proven were: (1) direct and prompt presentation of checks, (2) elimination of exchange charges, (3) reduction of time necessary for collection, (4) release and more equal distribution of the large balances kept by small banks with the banks in large centers for collection purposes. It recognized that there were disadvantages from the loss of exchange and the termination of many of the old relations between the smaller banks and their correspondents, but the advantages to business in general more than offset such losses.[21]

The Committee of Twenty-Five, appointed at the Kansas City convention of the American Bankers' Association, sounded out the opinion of bankers on par collection and claimed that the results showed that over seventy-five per cent of them were opposed to it.[22] In cooperation with the Federal Legislative Committee of the Association it endeavored to obtain amendments to the Federal Reserve Act enabling exchange charges to be made. Its efforts were increased when the Federal Reserve Bank of New York announced, on March 17, that after April 1, 1917, it would include in its par list the 114 banks in that district which were not remitting at par. The New York Bank expressed the hope that it would not be necessary to resort to forceful methods, such as the presentation of checks by express companies, to make collections. This announcement aroused a storm of protest.

The proposed amendments to the Federal Reserve Act were at this time under discussion and finally became law on June 21, 1917. Senator Hardwick of Georgia, had pro-

[20] *Fed. Res. Bull.*, Nov. 1, 1916, p. 599.
[21] *Fed. Res. Bull.*, Nov. 1, 1916, p. 601
[22] *Journal A. B. A.*, April, 1917, p. 807.

posed an amendment to section 13 permitting member and nonmember banks to make reasonable charges, in no case to exceed ten cents for each $100, or fraction thereof, based on the total of checks and drafts presented at any one time. The opponents of par collection believed this would relieve the situation but the Federal Reserve Board promptly declared its opposition to the amendment. The arguments against it were stated in a letter written by Governor Harding to Senator Owen on April 13, 1917, in which Governor Harding stated that such an amendment would defeat the efforts to establish universal par collection.[23] This letter was followed by more protests from the bankers, who asserted that Governor Harding had gone back on what he had said at the Kansas City convention where he stated that the clearing and collection provisions were really insignificant as compared with the underlying principles of the Act.[24] Shortly after this, Governor Harding, in a letter to Mr. Carter Glass stated that the Hardwick Amendment might result in exchange charges on checks used to make payments for Liberty Bonds, and urged a change in its provision so that it would not apply to such transactions. This letter aroused indignation because the bankers claimed that they were already agreeing to make no such charges on checks used to pay for Liberty Bonds.[25]

President Wilson, in a letter to Senator Owen, protested against the amendment as drawn, because, he said, to compel the reserve banks to pay exchange charges would be almost destructive of the functions of the reserve banks as clearing houses.[26] As a result of the opposition of the Federal Reserve Board and of the President the amendment was finally changed so as to permit the exchange charges to be regulated by the federal reserve banks, but expressly

[23] *Journal A. B. A.*, May, 1917, p. 885.

[24] *Journal A. B. A.*, May, 1917, p. 885.

[25] Report of Committee of Twenty-five, *Journal A. B. A.*, June, 1917, p. 963–964.

[26] 7 Fed. Res. Board, 1920, p. 347.

stipulating that no such charges should be made against the federal reserve banks. As finally enacted, the amendment to section 13 read: "That nothing in this or any other section of this act shall be construed as prohibiting a member or nonmember bank from making reasonable charges, to be determined and regulated by the Federal Reserve Board, but in no case to exceed 10 cents per $100 or fraction thereof, based on the total of checks and drafts presented at any one time, for collection or payment of checks and drafts and remission therefor by exchange or otherwise; *but no such charges shall be made against the Federal Reserve Banks.*" A bill introduced by Congressman Kitchin, giving permission to make exchange charges, failed of passage, partly because of opposition from the committee of Twenty-Five which claimed that the possibility of making exhorbitant exchange charges was not eliminated by the bill. This committee appeared to be fairly well satisfied with the Hardwick amendment as adopted. In view of later developments it is interesting to note that in its report to the 1917 convention of the American Bankers' Association this committee stated that the final clause of the amendment stating that no such charges should be made against the federal reserve banks referred only to checks and drafts which belonged to the federal reserve bank as principal, and that this interpretation had received the approval of the counsel of the American Bankers' Association.[27] Contrary to this view, this clause later became the main reason why the federal reserve banks maintained that par collection should be enforced. The Committee of Twenty-Five believed that a liberal interpretation of this amendment would eliminate most of the dissatisfaction. Now, as it believed that most of the work was over, it recommended that a smaller committee composed of five members be appointed to carry on the work. This suggestion was approved by the convention.

[27] *Journal A. B. A.*, Oct., 1917, p. 285–286.

Another part of the 1917 amendments of great interest was a change in section 13 of the Act stating that the federal reserve banks, solely for the purposes of exchange or of collection, might receive from any *nonmember* bank or trust company deposits of current funds in lawful money, national bank notes, federal reserve notes, checks and drafts payable upon presentation, or maturing notes and bills provided that "such nonmember bank or trust company maintains with the Federal reserve bank of its district a balance sufficient to offset the items in transit held for its account by the Federal reserve bank." This provision allowing nonmembers to open accounts of this nature was of importance in broadening the par collection scheme to include all but a small part of the banks of the country. There was some dispute as to what such nonmembers should be called. Some of them advertised themselves as "clearing members", and the Federal Reserve Board at first used this expression itself.[28] But in 1918 the Board decided that this was wrong since it might give the impression that they were members of the federal reserve system, and that the proper designation should be, "Nonmember depositor of the Federal Reserve Bank, through which checks on this bank are collectible." Not many of the state institutions even though they remitted at par took advantage of the permission to keep deposits with the federal reserve banks and collect checks through them, because they were already collecting at par through their correspondents, and deposits with these correspondents could count as reserve.[29]

To enlarge the clearing and collection system still further the Federal Reserve Board authorized the federal reserve banks after July 1, 1917, to receive for collection for account of member banks maturing notes and bills and miscellaneous drafts. An opinion of the counsel of the

[28] *Fed. Res. Bull.*, Nov. 1, 1917, p. 879.
[29] 4 Fed. Res. Board, 1917, p. 23.

Federal Reserve Board, however, narrowed the operation of the system slightly when he decided that private banks could not collect through the system because they had not been included in the definition given to the word "bank" in section 1 of the Federal Reserve Act. Although nonmember "banks" could collect, the word "bank" did not include private banks.[30] However, checks drawn on private banks could still be collected if such banks remit at par.

In order to clear up any doubt as to the meaning of the clause of section 13, giving the Federal Reserve Board power to determine and regulate exchange charges, the Attorney-General of the United States was asked to give an interpretation of this provision. He replied on March 21, 1918, that the Federal Reserve Board had no power to regulate exchange charges of nonmember banks who were not depositors under the clearing system. Only when they became members or depositors did the Board obtain control over them. If these nonmember banks insisted on making charges, checks on them could not be collected through the federal reserve bank since the clause "no such charges shall be made against the Federal reserve banks" prohibited such payment.[31]

The counsel of the American Bankers' Association forwarded a memorandum to the Federal Reserve Board in which he contended that the clause "no such charges shall be made against the Federal reserve banks" referred only to checks owned by the federal reserve banks as distinguished from checks deposited to be cleared or collected for the account of a member or depositor. Governor Harding asked Attorney-General Gregory whether this contention was sound. Mr. Gregory replied on April 30, 1918, that he could "not understand why checks deposited with a Federal reserve bank to be cleared or collected cannot be considered as owned by the bank." He cited a decision of the United

[30] *Fed. Res. Bull.*, Sept. 1, 1917, p. 693–694.

[31] 7 Fed. Res. Board, 1920, pp. 345–348; also *Fed. Res. Bull.*, May, 1918, pp. 367–371.

States Supreme Court (Burton vs. U. S., 196 U. S., 283) to show that a bank receiving checks on deposit gains title to such checks. But even were this not true, said Mr. Gregory, the language of the Act, as amended, certainly prevented the member and nonmember banks under any circumstances from making such charges against the federal reserve banks. Of that there could be no doubt, and furthermore, he concluded, the entire legislative history of the amendment proved beyond question that the clause "no such charges shall be made against the Federal reserve banks" was inserted to do away with the making of charges in the collection of checks.[32]

From the foregoing discussion it is apparent that the force of the restrictive clause in the Hardwick amendment was not fully realized at first by the opponents of par remittance, but when the Attorney-General of the United States gave as his opinion that this clause prevented the deducting of exchange charges on checks forwarded to drawee banks by federal reserve banks, and that checks drawn on banks making such deductions could not be collected through the federal reserve banks, the cry arose that the insertion of this clause had been brought about by unfair methods. Incidentally, the decision of the Attorney-General that the Federal Reserve Board had no power to fix exchange charges for banks which were neither members nor depositors in federal reserve banks was disappointing to federal reserve officials, for it seemed to restrict the broadening of the area of par remittance.

Officers of the federal reserve system were tireless in their efforts to persuade more and more nonmember banks to remit at par. Progress continued to be made during 1917 with the result that at the end of that year approximately 17,000 banks were remitting in full. During 1918 and the early part of 1919 the opposition to par collection was not so vociferous, probably because of the war. By

[32] 7 Fed. Res. Board, 1920, p. 348–349.

the end of 1918 approximately 19,000 banks were remitting without charging exchange.

A conference of federal reserve agents was held in Washington in December, 1918, and it was decided to make strenuous efforts to increase the number of banks on the par list. It was believed by the officers of the federal reserve banks that so long as approximately 10,000 banks refused to remit to the federal reserve banks at par the country would be denied the benefits of a universal par remittance system, for because of the prohibition contained in the Hardwick amendment checks upon such banks could not be handled through the federal reserve system. These exchange charging banks had, however, since the beginning collected checks upon banks remitting at par with the help of their city correspondents who acted as intermediaries. They received the benefits of the system but refused to share in the expense of maintaining it.

The method used to increase the number of banks agreeing to remit at par was first to persuade as many banks as possible in one state in each district to remit at par. When only a few recalcitrant banks were left in that state the federal reserve bank would announce that upon a certain date all the banks in that state would be placed upon the par list. Since it has been generally held that banks must pay in full in cash all checks drawn upon them which are presented over the counter, checks upon the banks still refusing to remit at par would be presented at the counter by an employee or an agent of the federal reserve bank instead of being returned through the mail. Where they refused to remit at par the reserve banks would make arrangements with the express companies or other local agencies to collect cash over the counter for the checks. Even the local post office was used in some cases for a limited period until this practice was stopped by the postmaster general. Where there was another member bank there was little trouble as this bank could be used as an

agent in collection. This presentation of checks at the counter resulted in many more banks agreeing to remit at par, but they did so most unwillingly and attacked the federal reserve banks for using what they called coercive measures. In some districts the local presenting agency got into trouble and refused to present any more checks. In others, the notary public refused to protest the checks when payment over the counter was refused. Many banks claimed that there was a deliberate attempt on the part of the federal reserve banks to accumulate checks and present them in such large amounts that the banks would find it impossible to continue in business because of the amount of cash needed. Where the local agencies refused to present checks it became necessary for representatives of the reserve banks to travel by train or automobile at considerable expense to the towns where the recalcitrant banks were located and make presentation of the checks at the counter. Many banks became almost frantic in their resistance and attacks upon the coercive methods of the reserve banks were heard all over the country.

The federal reserve banks retorted that since under the law they could not pay exchange, and since a bank must pay checks drawn upon it over the counter without deduction, it was necessary to use such methods because the Federal Reserve Act clearly placed upon the federal reserve banks the duty of bringing about universal par remittance and they could collect at par in no other way.

Few of the exchange charging banks could withstand these methods of compulsion, because of the large amount of cash needed to meet checks presented in this manner. They began to yield, and recalcitrant banks in state after state began to remit at par. They made vigorous protests and announced that the federal reserve banks were trying to ruin them. By the end of 1919 the number of banks on the par list had been brought to approximately 25,500, while the number of exchange charging banks was reduced to approximately 4,000. Continued pressure by the federal

reserve banks forced all but 1,700 banks on the par list by the beginning of 1921.[33] These reluctant banks were all in the Richmond, Atlanta, and Kansas City districts.

The Federal Reserve Board went to considerable trouble to explain its policy and the reasons for sanctioning compulsory methods. In a letter to the federal reserve agent of one of the southern federal reserve banks upon the resignation of one of its directors as a protest against the "coercive" measures of the federal reserve banks, Governor Harding explained the situation at great length.[34] He said that the provisions of the Federal Reserve Act laid upon the Federal Reserve Board the duty of establishing a universal country wide program of par collection and the policy of forcing banks to remit at par was absolutely necessary because such a system, to be successful, would require *all* checks on *all* banks to be cleared and collected in this manner. Although the provisions of section 13 said that a reserve bank *may* receive from member banks deposits of checks and drafts payable on presentation, yet "it is clear that a Federal Reserve Bank in order to do any business whatever must exercise some of the permissive powers authorized by law. It would be impossible otherwise for a Federal Reserve Bank to afford to its member banks many of the privileges which the law clearly contemplates and to which the member banks are clearly entitled."[35] Furthermore, section 16 made it *obligatory* on the federal reserve banks to receive on deposit *at par*, from *member banks*, checks and drafts drawn upon any of its de-

[33] 7 Fed. Res. Board, 1920, p. 63.

[34] In its 1920 report the Federal Reserve Board in commenting on the opposition aroused to par collection stated, "This development in the check clearing and collection system has been accomplished in the face of continuous opposition on the part of some member and nonmember banks. It is evident that as the merits of par collection are becoming more widely known fewer banks are participating in the opposition, but the banks which continue to oppose par collection are well organized and their opposition appears to be as vigorous as ever." (7 Fed. Res. Board, 1920, p. 63).

[35] 6 Fed. Res. Board, 1919, p. 41; also *Fed. Res. Bull.*, Dec. 1, 1919, pp. 1113-1114.

positors. While this does not *compel* the reserve banks to receive at par checks on *nonmembers*, yet, argued the Board, the federal reserve banks undoubtedly have the *right* to receive from any of its member banks *any checks payable on presentation no matter on whom they might be drawn*. Then, added Governor Harding, "The whole purpose of the Act demands that in justice to member banks they should exercise that right." In addition, section 16 gave the Federal Reserve Board the power, at its discretion, to exercise the functions of a clearing house for the reserve banks and also to require the reserve banks to act as clearing houses for member banks. But these functions could not be performed satisfactorily unless all checks could be collected. Furthermore, the Attorney-General had ruled that a federal reserve bank could not legally pay any charge to a member or nonmember bank for the collection or remittance of a check. So, in the opinion of the Federal Reserve Board, there was nothing left to do but to collect checks on banks refusing to remit at par by any method which would not result in the payment of such exchange charges, no matter how expensive this method might be. Then, the letter concluded, "The action of the various federal reserve banks in extending their par lists has met with the cordial approval of the Federal Reserve Board, which holds the view that under the terms of existing law the federal reserve banks must use every effort to collect all bank checks received from member banks at par."

The banks which had been in the habit of making deductions in remitting for checks drawn on them argued vigorously against such a policy, claiming that they were entitled to make such charges, that it was not an exchange but a service charge which was necessary to reimburse them for the expense involved in the transfer of funds. Most of the agitation for par collection, they said, came from manufacturers and jobbers who would be the ones to profit inasmuch as they could get full credit for all checks de-

posited by them, instead of as formerly in many cases, having the deduction charged to them by the bank in which they deposited the checks. They stated further that par collection of checks was not made obligatory by the Federal Reserve Act, that the Federal Reserve Board in so acting was assuming autocratic power, and that it was an attempt to coerce the nonmember banks into joining the system or else going out of business.

Early in 1921 it began to look as though nation-wide par remittance would soon be a reality. Only 1,700 banks remained to be brought in and these were all in the South. The campaign of compulsion had left most of the southern banks alone until the rest of the country was forcibly converted. With the attempt in 1920 to force these southern banks into line the opposition in that section of the country became thoroughly organized. Resistance from this section was to give the par remittance campaign its first setback, a setback from which it never recovered. The southern banks, realizing that pressure would be brought upon them, laid their plans for meeting the attack.

On October 16, 1919, a meeting of Louisiana bankers adopted a resolution that banks not wishing to remit at par should print across the face of their checks, "This check will not be paid through express companies, post offices, or any Federal reserve bank or its agents".[36] Mississippi bankers on October 24, adopted resolutions asking for a congressional investigation of the methods used to enforce par collection. They approved the institution of a suit to test the constitutionality of sections 13 and 16, stated that a fair charge was one-tenth of one per cent, with a minimum of ten cents, and urged those banks desiring to make exchange charges to print on their checks, "Payable in cash to the original payee, otherwise in exchange at a maximum service charge of $\frac{1}{10}$ of 1 per cent." The counsel of the American Bankers' Association was not cer-

[36] *Journal A. B. A.*, December, 1919, p. 334.

tain, however, whether a check containing this last statement was negotiable, although that recommended by the Louisiana bankers, he was certain, did not impair such negotiability.[37] The Country Bankers' Association of Georgia had been organized in 1917, and when on December 23, 1919, the Atlanta Bank notified all banks in that district that they were to be placed on the par list, plans were laid for testing in the courts the power of the Bank to do so.

The first step taken by the resisting banks was the securing early in 1920 of an injunction against the Federal Reserve Bank of Atlanta in the Superior Court of Fulton County, Georgia. This injunction restrained the Atlanta Bank from collecting checks drawn upon the plaintiff banks in any other manner than through the mails. The plaintiffs contended that the federal reserve bank was saving the checks until it had accumulated a large number and was then presenting them at the counter of the drawee banks for payment in full in cash, in the hopes that the banks would either be forced to give in or go out of business. The Federal Reserve Bank of Atlanta denied this contention and secured the removal of the case to the United States District Court for the Northern District of Georgia. The plaintiff banks claimed that the federal courts had no jurisdiction. This claim was rejected by the court. The Federal Reserve Bank of Atlanta demurred to the complaint of the plaintiff banks. The federal court upheld the demurrer which meant that the facts, as stated by the plaintiffs, did not constitute a cause of action. The plaintiffs took the case on appeal to the United States Circuit Court of Appeals for the Fifth Circuit where, on November 19, 1920, the decree of the lower federal court was affirmed.[38] Appeal was taken to the United States Supreme Court. The decision of the Supreme Court will be discussed in the next chapter.

[37] *Ibid.*, pp. 334–335.

[38] This decision is found in 7 Fed. Res. Board, 1920, pp. 330–334. Also in 269 Fed. 4.

While the suit just discussed was progressing a number of other means of combating par remittance were being developed. These took the form of organizing new bankers' associations, of securing investigations by Congress, and obtaining the passage of laws by state legislatures, as well as furthering attacks upon par remittance through the courts.

The National and State Bankers' Protective Association was organized in New Orleans early in 1920. Charles de B. Claiborne, President of the Louisiana Bankers' Association and Vice-President of the Whitney-Central National Bank of New Orleans, was elected chairman of the association. The conference adopted resolutions approving the purposes of the Federal Reserve Act, but attacked certain particular features violently, namely, par collection and the coercive and oppressive policies of the Federal Reserve Board. The resolutions requested Congress to institute an investigation of the administration of the Federal Reserve Act with regard to these alleged coercive and dictatorial attempts to compel the state banks to remit at par, the large profits made by the reserve banks, the large salaries and bonuses paid to their employees, competition with member banks, open market operations, the refusal to discount eligible paper and paper secured by Liberty Bonds, the inflation of the currency resulting in the rise in the cost of living, the enormous amounts spent by the reserve banks in enforcing par collection, and the extent to which power had been usurped and abused by the Federal Reserve Board.[39] Membership in this association was composed of bankers from eight federal reserve districts. The organization was given a permanent status in Washington, D. C., in May, 1920, when many of its members appeared before Congressional committees. State legislatures in the South and West came to the aid of this association. Beginning with Mississippi in March, 1920, the state legislatures of

[39] *Journal A. B. A.*, March, 1920, pp. 497–498.

Louisiana, South Dakota, Georgia, Alabama, North Carolina, Tennessee, and Florida passed laws during 1920 and 1921 making it legal for banks in those states to deduct exchange on checks presented to them by an agent of the federal reserve bank. The majority of these state laws made it illegal to protest a check because of refusal to remit in full.[40] The North Carolina statute gave rise to an important law suit which will be discussed later.

The clamor against par remittance was so strong that it reached the United States Senate. That body on January 19, 1920, adopted a resolution requesting the Federal Reserve Board to inform the Senate whether the Board or any reserve bank had used coercive methods or threats to require the state banks to submit to the rules or regulations of the Federal Reserve Board and the reserve banks, and also whether such methods had been used to compel the state institutions to join the system.

Governor Harding replied for the Board on January 26, giving the history of the campaign for par collection and the provisions of the law, and informed the Senate that the Board "has never resorted to any method of coercion to compel state banks to join the Federal Reserve System nor has it by threats or other coercive means attempted to require such state banks to submit to rules or regulations made by the Federal Reserve Board or any Federal reserve bank. Furthermore, the board has never instructed or knowingly consented to any Federal reserve bank's adopting such means in its efforts to extend its par lists. . . . So far as the Federal Reserve Board is aware, the Federal reserve banks themselves have never been anything other than both patient and considerate in explaining the necessity for exercising what is after all an undisputed legal right to ask for payment over the counter, an inherent right in the holder of any check or bank draft."[41] If any agent

[40] The statutes passed by Miss., La., S. Dak., Ga., and Ala., are printed in 7 Fed. Res. Board, pp. 327-329.

[41] 7 Fed. Res. Board, 1920, pp. 336-339.

had acted in an offensive manner it had been without the authority or consent of the Reserve Board and banks, said Governor Harding and there had been no accumulation of checks with the express intent of injuring the banks.

Additional evidence of opposition is found in the hearings before the Committee on Rules of the House of Representatives in May, 1920, on a resolution providing for the investigation of the administration of the Federal Reserve Act.[42] Practically all of the testimony centered around the par collection movement. A delegation of bankers from 24 states was present and made a strong protest against par collection. A large number of affidavits were submitted to the committee, which if true, showed that in some districts the agents of the reserve banks had conducted themselves in a very offensive manner in trying to force the banks to remit at par. Most of these affidavits told of episodes in Nebraska, in the district of the Omaha branch of the Kansas City Bank. Mr. Woods Cones, President of the Cones State Bank of Pierce, Nebraska, took the lead in making protests from that section. He claimed that under the Nebraska law he was compelled to keep only $25,000 in cash in the vaults, while at one time the agents of the federal reserve bank had presented checks amounting to $31,900 for which they demanded cash. The Federal Reserve Bank of Kansas City claimed that Mr. Cones had been at the head of the fight against par collection and was reported to have made many false and misleading statements.[43] The affidavits supporting Mr. Cones' statements make very interesting reading, to say the least. They relate how agents of the reserve banks entered the banks and displayed revolvers while waiting for the cash for the checks presented by them. But a close study of these affidavits seems to show that the revolvers were carried not for the purpose of intimidating the bank officials but for protecting

[42] Hearings before the Committee on Rules, House of Representatives, 66th Congress, 2nd Session on H. R. 476, pp. 20; 23–36.

[43] 7 Fed. Res. Board, 1920, p. 356.

against loss from holdups. It was furthermore claimed that agents of the Kansas City Bank attempted to organize national banks in this section to compete with the state banks.[44] The following testimony by W. C. Thomas, President of the Rock Creek State Bank, of Rock Creek, Iowa, is typical of the statements made before the comimttee:[45]

"We are 116 miles from Chicago; three or four trains each way every day between Chicago and our town. We had a similar experience to Mr. Cones; they sent through items to the express agent after accumulating them for as long as 2 weeks or 20 days to be presented at one time, and had at one time $14,000. Our bank is a $30,000 bank and we carry from $5,000 to $8,000 reserve. He collected two or three batches of checks, but as his hours were from 7 A.M. to 4 P.M. and it required him to stay until nearly 5 o'clock to get rid of this money he objected to carrying it, and at last finally dug up some instructions from the Interstate Commerce Commission which did not require him to go out and collect items, and he finally advised the Federal Reserve that the items were there and that he had notified the bank to pay them, but they had not done so, and that the items were still there. They sent a man over to take them up, and he came with about $5,000 worth of checks and at the same time had about $12,000 worth in the express office. He had an order to get these checks in addition to what he had with him, and expected to take all the cash we had.

"The express agent told him he had not received the checks from the Federal reserve bank but from the express company and that that was where he was going to turn them back, and the Federal reserve man did not secure these checks and they were turned back, but we paid him the checks he had. I think he made six or seven trips after that about every other day; he came in the forenoon and went back in the afternoon. He admitted to me that it was costing them about $30 per day to make the collections. Every time he came he kept hunting somebody to act as their agent. He first offered the express agent $30 per month in addition to what he was getting as express agent and kept raising the limit until he got up to $60 per month to do this collecting. He tried the postmaster and the undertaker of the town; offered him $30 per month but

[44] Hearings before the Committee on Rules, pp. 30–31.
[45] *Ibid.*, pp. 37–38.

could not get anybody and could not get a notary to protest his checks. There was one check for $10,000 on which payment had been ordered stopped. He said he had never before seen a town where the bank had everybody sewed up. We had made no effort to sew anybody up; simply stood on our rights, and our customers recognized the situation. He hired a taxicab and went to the county seat to secure a notary to protest the checks and he admitted to me that it was costing $25 to $30 per day. Mr. Powell from Chicago finally came down and asked us if we would not agree to an armistice, and we agreed to remit at par until further orders. We are not obligated to any stated time and can abrogate that agreement at any time. This young man who came from Chicago went to our county sheriff and wanted to get a permit to carry a revolver, and what he wanted to carry a revolver for I do not know, but he did carry it and showed it to the people in town, but whether it was to protect himself or intimidate us I do not know."

Similar testimony was given by bankers from Mississippi, Idaho, and Colorado.

Governor Harding was one of the witnesses before this committee and stated that he did not blame the country banks for resisting, but that it was up to the Federal Reserve Board to enforce the law as interpreted by the Attorney-General of the United States.[46] He admitted that in many cases, when checks were presented by agents, only cash and not exchange even to the full amount was accepted unless the bank agreed to sign the agreement to remit at par.[47] Governor Harding was asked by members of the Committee on Rules, why the reserve banks could not handle merely checks on member banks, and he replied that the law required the reserve banks to take from member banks *all checks payable on presentation.* Upon being pressed further he stated:

"I want to pass the buck right back to congress. You can not escape it. You put us in a very awkward position; you passed a law open to two constructions and, being constructed

[46] Hearings before the Committee on Rules, pp. 42–45.
[47] *Ibid.*, p. 46.

that way, you put no penalty on it and you asked us to enforce this law and we are trying to do it. I have pointed out if the committee wants the law changed, Congress should change it. All I ask is if Congress does change it, that it will change it all the way through so that it will affect nonmember banks and member banks alike."[48]

In closing, Governor Harding urged the Committee not to pass a law depriving the member banks of this source of profit while permitting the state banks to continue to make exchange charges. He further urged that they should not compel the reserve banks to absorb the charges because $135,000,000 would be required and the reserve banks were not making enough to pay it. He concluded, "Just charge the sending bank with the amount it will have to pay".[49]

On the same day that this hearing was being conducted before the Committee on Rules another hearing was in progress before the House Committee on Banking and Currency on H.R. 12379 (a bill introduced by Mr. Steagall of Alabama amending section 13 so as to eliminate the provision that charges should be regulated by the Federal Reserve Board and the provision that no such charges should be made against the Federal Reserve Banks). A number of national and state bankers gave testimony before the committee and urged the passage of the bill.[50]

Mr. E. L. J. Miles, of Mancelona, Michigan, stated that the result of an inquiry in that state showed that a majority of the banks had been forced into par collection and opposed it.[51] Mr. W. E. Sprecher, President of the Wisconsin Bankers' Association, said that the majority of the banks in Wisconsin had been put on the par list by force,[52] and that the banks in the agricultural districts needed this revenue to exist.[53] Mr. C. C. Strawn, of Franklin, Virginia,

[48] *Ibid.*, pp. 54–55. [49] *Ibid.*, pp. 56–57.

[50] Hearings before the Committee on Banking and Currency of the House of Representatives on H. R. 12379.

[51] *Ibid.*, p. 81.

[52] *Ibid.*, pp. 59–60.

[53] *Ibid.*, p. 71.

Chairman of the Par Clearance Committee of the Virginia Bankers' Association, said that similar conditions existed in his state.[54] Mr. Thomas J. Early, President of the North Dakota Bankers' Association, said that the majority of banks in the northwest were on the par list unwillingly.[55] Mr. J. S. Peters, of Virginia, said, "With the big-stick methods, with the big stick and coercive methods used by the Federal Reserve Board today they absolutely have the power to drive every little bank in the United States out of business or make them do their own bidding and come up and eat out of their hands."[56] Mr. G. G. Spier, Banking Commissioner of Kentucky, said that the state banks were fighting for their very lives and that the Federal Reserve Board was endeavoring to drive all recalcitrant banks out of existence.[57]

Statements and quotations of this nature might be multiplied without end, but these are typical, and show that opposition to par collection was not centered merely in the southern states but was a nation-wide movement. The presence of so many bankers in Washington in May, 1920, was not due merely to these hearings before the Congressional committees, but to the fact also that at this time the National and State Bankers' Protective Association which had been formed in New Orleans early in 1920 was at this time given an organization of a permanent form. Mr. Charles de B. Claiborne of New Orleans is the chairman of this association and upon the death of Mr. M. J. Dowling of Olivia, Minnesota, became chairman of the Committee of Five of the American Bankers' Association. At the 1920 convention of the American Bankers' Association Mr. Claiborne made a violent attack upon the methods of the Federal Reserve Board in these words:[58] "Not only

[54] *Ibid.*, p. 87.
[55] *Ibid.*, p. 22.
[56] *Ibid.*, p. 74.
[57] *Ibid.*, p. 77.
[58] 46 A. B. A., 1920, *Journal A. B. A.*, Nov., 1920, p. 385.

would the Federal Reserve Banks not recede or compromise, but they persisted in their plan to force upon the banks this idealism of 'par collection'; and in order to force it, resorted to all means of persecution, and in some instances to methods questionably legal which must be condemned by every fair-minded banker—a display of such energy and coercion as could have been much more effectively used against the Socialists and Bolshevists of this country than against the law-abiding bankers. To think that a government agency of this United States, backed by the machinery of this all-powerful country of one hundred million people, did not and could not depend upon the justice of its cause for success, but upon might and persecution."

Support to the program of opposition to par collection was given by the National Association of Supervisors of State Banks which, at its Seattle meeting in 1920, passed resolutions pledging its support to those who were attempting to gain permission for banks to make reasonable charges for exchange. The association requested the American Bankers' Association and all the state bank associations to assist in so amending the law.[59]

An example of the action taken by some of the state bankers' association can be found in the proceedings of the 1920 convention of the Minnesota Bankers' Association. In his presidential address, Mr. M. J. Dowling, of Olivia, read the South Dakota law permitting banks in that state to charge exchange, and penalizing any notary public who protested checks because they were not paid at par. Commenting on this law, Mr. Dowling said,[60] "I will say that it is my belief that this piece of legislation will be something like the Tea Party in Boston and result in arousing the sentiment and the intelligence of the country bankers, both state and national, throughout America, in order that we may get paid for services performed even though it be a

[59] *Journal A. B. A.*, August, 1920, p. 68.
[60] *Proceedings Minnesota Bankers' Association for 1920*, pp. 20–21.

mite, when the next Congress takes office, and the next President, be he Harding or Cox, occupies the White House." This convention passed the following resolutions:[61]

> "Resolved, that we deplore and protest most vigorously against the policy of the Federal Reserve Board to enforce universal par clearance of checks, and this association does hereby request Congress to so amend the Federal Reserve Act that member banks may not be forced to bear so great a burden and that the Federal Reserve Banks be required to pay to member banks a reasonable interest on daily balances and render services to member banks rather than accumulate large profits."

A fight was made in the convention to amend this statement so as to strike out the clause relating to the payment of interest, but it was unsuccessful. Resolutions were also passed commending the National and State Bankers' Protective Association.

Meanwhile the state legislatures had been lending their assistance to the opponents of par collection. Mississippi in a statute approved March 6, 1920, made it mandatory on the banks in that state, except in certain special cases, even upon the national banks, unless the courts held otherwise, to make exchange charges on checks, drafts, and bills presented by federal reserve banks or their agencies at the rate of $\frac{1}{10}$ of 1 per cent, and not less than 10 cents on any one item. However, if the national banks refused to make such charges, any state bank located in the same municipality with a member of the federal reserve system could do as it pleased about making such charges. Furthermore, it was made illegal for any officer of the state to protest checks or drafts for non-payment upon the refusal to remit in full.

Louisiana followed with a similar law but made it optional and not mandatory to make such charges. South Dakota on July 3, 1920, approved a similar statute giving

[61] *Ibid.*, pp. 150–152.

the banks the right to make such deductions if they cared to do so, prohibiting notaries from protesting unpaid items, and further stated that if a single holder of checks presented at any one time an amount greater than a bank was required by law to keep as a reserve in its vault the bank might make the payment in exchange instead of in cash. Georgia, on August 14, 1920, gave permission for its banks to remit either in money or exchange on approved reserve agents for checks presented by any bank or its agency. A charge of not exceeding $\frac{1}{8}$ of 1 per cent might be made. Alabama, on September 30 of the same year, made it mandatory on banks of that state to charge exchange. This law also stated that when checks were presented by a federal reserve bank or its agency the paying bank might either remit in cash or in exchange on its reserve agents, and make a charge of $\frac{1}{8}$ of 1 per cent for such exchange, with a minimum of 10 cents. The protesting of checks for nonpayment in such cases was rendered illegal.[62] In 1921 three more states passed similar laws, North Carolina, Tennessee, and Florida, making eight in all. Unsuccessful attempts were made in other states to secure similar enactments.

Leaving the history of the par collection litigation in the courts to be discussed in the next chapter, it may now be asked how the par collection controversy affected the growth of membership in the federal reserve system. The answer to this question is that it distinctly lessened the desire of the state institutions to join. The hostility stirred up has been outlined at length and it is clear that the methods employed by the federal reserve banks kept many banks out of the federal reserve system. They did not wish to put themselves under more direct control of officials whose attitude they termed "dictatorial" and whose methods they deemed to be "coercive." And yet, in the

[62] For copies of the laws passed by Miss., La., South Dakota, Ga., and Ala., see 7 Fed. Res. Board, 1920, p. 329.

beginning, it had been hoped that one of the chief inducements to membership would be the development of a collection system operating through the federal reserve banks. The Federal advisory council had said on December 24, 1914: [63]

"The chief inducement, however, for State banks to come into the system is in connection with the clearing of so-called country checks and until this matter is developed to such a point that the State banks may definitely know just what advantages may accrue to them in that connection it seems futile to prepare regulations for their joining the system."

It will be remembered that the Secretary of the Federal Reserve Board had said in 1914: [64]

"We may say, therefore, that the large entry of State banks into the system depends in a very large measure on the way in which the clearance feature is handled and the extent to which the clearing function is taken over by the Federal Reserve Banks under instructions from the Federal Reserve Board. Provided that this work is undertaken courageously and successfully, the result will be to enlarge greatly the membership of the Federal Reserve System."

The opposition of bankers led the Federal Reserve Board to remark disappointedly in its 1916 report: "It had been expected that upon the organization of the clearance and collection system a considerable number of state institutions would find it to their advantage to apply for membership." The Journal of the American Bankers' Association stated editorially in June, 1917, that the par collection campaign had alienated the support of the state institu-

[63] 5 Fed. Res. Board, 1918, p. 767.

[64] 40 A. B. A. 1914, Com. and Fin. Chron. Supp. At the same time Mr. E. L. Howe, President of the Princeton Bank and Trust Company of Princeton, New Jersey, sounded this warning: "The policy of these gentlemen (The Federal Reserve Board) in the collection of country checks will carry with it great possibilities for good or for evil, as upon their decision to a large degree hinges the decision of the state institutions to support or antagonize the new banking system." Howe, E. L., *Trust Companies Magazine,* Dec., 1914.

tions and had changed their attitude from one of patriotic support in war time to that of lack of confidence in the Federal Reserve Board. "Country bankers softened," ran the editorial, "but the express companies remained as a part of the collection system. Members of the Federal Reserve Board made eloquent appeals for the support of the government and sharpened the axe to cut further into the country banker's profits." Mr. John H. Puelicher, chairman of the Federal Reserve membership committee of the American Bankers' Association reported to the 1920 convention that it had become practically impossible to persuade more state banks to join because of the coercive methods used in the par collection campaign.[65]

As a result of the various lawsuits brought against the federal reserve banks compulsory methods have long since been abandoned. Withdrawals from the par list since 1921 have increased the number of nonremitting banks to approximately 4,000. Although 22,000 banks now pay in full it must be regretted that the system is not universal. The number of items collected through the federal reserve banks has grown to tremendous proportions, amounting in 1926 to nearly 800,000,000. The value of these items was nearly $260,000,000,000. Surely, to have developed a system of such proportions is no mean accomplishment. It has increased the efficiency of the check as a means of payment, abolished a large proportion of the "float," shortened the time required to transfer funds, saved a large amount of interest, and has been of incalculable benefit to the business interests of the country.

There is little justification now for the deduction of exchange. As the Federal Reserve Board has said: [66]

"To the extent that the practice of charging exchange is continued under the operation of the Federal Reserve System, it is an anachronism which permits the charging banks to impose

[65] *Journal A. B. A.*, November, 1920.
[66] 7 Fed. Res. Board, 1920, p. 67.

a charge upon commerce and industry after they have ceased to perform the service which in former times justified the imposition of such a charge."[67]

[67] Many state bankers realized the advantage of par collection. Mr. W. H. Doyle, Cashier of the State Bank of Platteville, Platteville, Wisconsin, is such a banker. In an address before the 1920 convention of the American Bankers' Association he reminded the bankers of the many evils of the old system when banks were constantly searching for new correspondents who would collect for them at par and yet at the same time allow them to deduct exchange on their own checks. He dwelt upon the evils of the circuitous routing of checks to dodge exchange charges, the delay and uncertainty with regard to ultimate payment, the resulting padding and pyramiding of reserves, the loss of interest, and the enormous float. The old system robbed the check of its efficiency. Then he asked: "Can any thinking man in this day and age of progress—of development and efficiency in every line of business—for a moment conscientiously argue that any such obsolete, dangerous, unscientific, and indefensible clearance method shall any longer handicap to-day's requirements of trade and industry? . . . Our banks were not chartered solely for the benefit and selfish interests of stockholders. They were chartered and created to serve the trade and commerce of our country; to facilitate the commercial operations of our people, and we are derelict in our duty when we fail to provide facilities which will enable our institutions to function not only in the highest interests of trade and industry but in the highest interests of the general public." *Journal, A. B. A.*, November, 1920, p. 393.

CHAPTER XIV

THE PAR COLLECTION LITIGATION AND ITS RESULTS

When par remittance was made compulsory for all members in 1916 many bankers wished to institute legal proceedings to test its constitutionality. They asserted that inability to deduct exchange charges in remitting to the federal reserve banks deprived them of property without due process of law, a procedure forbidden the Federal government by the Fifth Amendment. The entrance of the United States into the war early in 1917 caused a postponement of plans for legal opposition, and by the end of the war the member banks had apparently become more or less reconciled to par collection. When the federal reserve banks in 1919 began the use of compulsion to force nonmembers on the par list talk of legal proceedings revived, but little was done until the Federal Reserve Bank of Atlanta late in 1919 announced that it would make presentation of checks at the counters of nonremitting banks for payment in cash. By this time nearly all of the nonmembers in other districts had been forced on the par list. Had it not been for the resistance of the nonmembers in the Atlanta district universal par remittance would probably now be a reality. Opposition was strong in the Minneapolis, Kansas City, and Richmond districts, but it was the opposition of the bankers in the Atlanta district that stopped the progress towards universal par remittance. Bankers and legislatures in other districts soon entered the fight.

From 1920 to 1927 six suits were instituted against federal reserve banks. Several others were narrowly avoided only through the abandonment of forceful methods by certain federal reserve banks. Four decisions by the United

States Supreme Court were necessitated, three concerning suits against the Federal Reserve Bank of Atlanta and one involving the Federal Reserve Bank of Richmond.[1]

Two other cases against the Federal Reserve Banks of Cleveland and San Francisco were settled by mutual agreement in 1925 after decisions by lower federal courts.[2] Another case instituted by the First State Bank of Hugo, Minnesota against the Federal Reserve Bank of Minneapolis has not yet been finally determined.

The First Atlanta Bank Case

The suit against the Federal Reserve Bank of Atlanta began, when on January 22, 1920, a number of Georgia banks filed a petition in the Superior Court of Fulton County, Georgia, asking for an injunction against the Atlanta Bank to restrain it from collecting checks drawn upon the plaintiff banks in any other manner than through the mails. The plaintiffs contended that the federal reserve bank was saving checks until it had accumulated a large number and was then presenting them at the counters of the drawee banks for payment in full in cash, in the hope that the banks would either be forced to remit at par or go out of business. They stated that such a practice

[1] These cases were:
(1) American Bank and Trust Co. v. Federal Reserve Bank of Atlanta, 256 U. S. 350 (1921); also 8 Federal Reserve Board, 1921, pp. 357–358.
(2) Same title as above, 262 U. S. 643 (1923); also 10 Federal Reserve Board, 1923, pp. 296–297.
(3) Farmers and Merchants Bank of Monroe v. Federal Reserve Bank of Richmond, 263 U. S. 649 (1923); also 10 Fed. Rés. Board, 1923, pp. 298–300.
(4) Pascagoula National Bank v. Federal Reserve Bank of Atlanta, 271 U. S. 685 (1926); *Fed. Res. Bull.*, June, 1926, p. 378; 13 Fed. Res. Board, 1926, pp. 25–27.

[2] These cases were:
(1) Farmers' and Merchants Bank of Cattlettsburg, Kentucky v. Federal Reserve Bank of Cleveland, 286 Fed. 160 (1922); also 9 Fed. Res. Board, 1922, p. 271.
(2) Brookings (Oregon) State Bank v. Federal Reserve Bank of San Francisco, 281 Fed. 222 (1922); also 9 Fed. Res. Board, 1922, p. 265.
(3) The final settlement of these two cases by agreement is reported in 12 Fed. Res. Board, 1925, pp. 34–35.

necessitated the maintenance of such a large amount of cash in the bank to meet such checks that it would be impossible for them to make enough profit to remain in business. This, they claimed, deprived them of property without due process of law and was contrary to the Fifth Amendment. If checks were sent to them through the mails they could remit by a draft upon a correspondent bank, thereby removing the necessity for keeping a large amount of cash. Behind their argument, of course, lay the fact that if they remitted to the reserve bank by a draft on a correspondent they deducted exchange, but if they paid over the counter they had to pay the full amount of the checks in actual cash. It must be reiterated that the controversy involved only remittances to the federal reserve banks for checks coming into the possession of the reserve banks and returned to the drawee banks for payment. It does not involve exchange charges made by one bank against another bank, a practice that still exists in many sections of the country. Neither does it involve the charges made by many banks for collecting checks deposited or presented by their customers.

The Fulton County Court issued the injunction as requested. Thereupon, the Federal Reserve Bank of Atlanta secured the removal of the case to the United States District Court for the Northern District of Georgia. The plaintiffs unsuccessfully opposed this transfer on the ground that the federal courts had no jurisdiction in this case. The Atlanta Bank demurred to the complaint. The federal court upheld the demurrer, which meant that the court believed that the facts, as stated by the plaintiffs did not constitute a cause of action. The complaint was therefore dismissed. The plaintiffs took the case on appeal to the United States Circuit Court of Appeals for the Fifth Circuit, where on November 19, 1920, the decree of the lower court was affirmed.[3]

[3] 269 Fed. 4; also 7 Federal Reserve Board, 1920, pp. 330–334.

The state banks then appealed to the United States Supreme Court where on May 16, 1921, a decision was rendered affirming the jurisdiction of the federal courts in the question at issue. But the decisions of the lower courts as to whether a cause of action had been stated in the complaint were reversed. The court speaking through Mr. Justice Holmes said, "On the merits we are of the opinion that the court below went too far. The question at this stage is not what the plaintiffs may be able to prove, or what may be the reasonable interpretation of the defendant's acts, but whether the plaintiffs have shown a ground for relief if they can prove what they allege." The Federal Reserve Bank of Atlanta had contended that the holder of a check had an *absolute* right to present it at the counter of the drawee bank for payment. The court denied the validity of this argument, declaring that no right were absolute for they were limited by the rights of others. Therefore, the rights of the Atlanta Bank in this case were limited by the rights of the plaintiff banks. If the plaintiffs could prove what they alleged, their rights may have been violated, so they must be given an opportunity to prove their case. The court stated:

> "It is not enough to refer to the general right of a holder of checks to present them, but it is necessary to consider whether the collection of checks and presenting them in a body for the purpose of breaking down the petitioner's business as now conducted is justified by the ulterior purpose in view. . . . We do not need aid from the debates upon the statute under which the Reserve Banks exist to assume that the United States did not intend by that statute to sanction this sort of warfare upon legitimate creations of the states."

The case was ordered back to the lower courts for trial on the merits.[4]

The state banks were jubilant over this decision, es-

[4] American Bank and Trust Company v. Federal Reserve Bank of Atlanta, 256 U. S. 350 (1921); also 8 Federal Reserve Board, 1921, pp. 357–378.

pecially so because the concluding words of the court seemed to show that it was sympathetic with the attitude of the plaintiff banks. The Federal Reserve Board endeavored to minimize the victory of the Georgia banks and said that the decision meant nothing more than that the case must now be tried on its merits, that is, to see whether the plaintiffs could prove the facts which they alleged in their complaint.[5] That was true, but at the same time, one can well understand why the plaintiffs rejoiced, for two federal courts had said that even if the facts stated in the complaint were true they would not constitute a cause of action. Had the Supreme Court upheld this view the Georgia banks would have been utterly routed in their campaign. So the decision really gave them a fighting chance.

The joy of the plaintiff banks was, however, short lived, for after a trial, Judge Evans of the United States District Court for the Northern District of Georgia decided on March 11, 1922, that the Federal Reserve Bank of Atlanta had violated no rights of the plaintiff banks in presenting checks at their counters.[6] The Atlanta Bank was cleared of the charge of using oppressive or coercive methods. The charge that the reserve banks had accumulated checks so as to compel the plaintiffs to keep on hand an unreasonable amount of cash was not sustained. Judge Evans further went on to say that the federal reserve banks might collect *all* checks *payable on presentation*, including checks drawn on nonmember banks, but under the Federal Reserve Act they could not pay any exchange charges. They might employ any proper instrumentality or agency to collect checks drawn on banks refusing to remit at par. Furthermore, there was no objection to mentioning certain towns or cities as being on the par list, but in lists of individual banks, the nonmembers should not be included without their consent.

[5] 8 Federal Reserve Board, 1921, p. 69.

[6] 280 Fed. 940; also 9 Federal Reserve Board, 1922, pp. 258–259.

It should be mentioned, however, that before the trial the defendant reserve bank agreed that in the future it would accept a draft on a correspondent bank in payment for checks presented at the counter. But, the draft must be for the full amount. Up to that time the Federal Reserve Bank of Atlanta had insisted upon payment in actual cash when checks were presented over the counter. This was an important modification in the attitude of the defendant reserve bank and removed much of the opposition of the state banks.

The decision of the lower court was sustained on appeal, November 2, 1922, by the United States Circuit Court of Appeals for the Fifth District. This court agreed with the lower federal court that no evidence had been offered to sustain the charge that the Federal Reserve Bank of Atlanta had attempted to oppress the state banks or drive them out of business.[7] The state banks again appealed to the United States Supreme Court which on June 11, 1923, affirmed the decisions of the lower federal courts. The plaintiff banks had contended that it was beyond the powers of the federal reserve banks to collect checks on banks which were not members of the federal reserve system, or affiliated with it by the establishment of exchange balances, where these banks had definitely refused to remit at par. The Supreme Court denied the validity of this contention both under the common law and the Federal Reserve Act, as the Federal Reserve Act definitely provided for the collection of all checks payable upon presentation within each federal reserve district. The court said in part:[8]

"Federal reserve banks are, thus, authorized by Congress to collect for other reserve banks, for members, and for affiliated nonmembers, checks on any bank within their respective districts, if the check is payable on presentation and can in fact

[7] 284 Fed. 424; also 9 Federal Reserve Board, 1922, pp. 358–359.

[8] 262 U. S. 643 (1923); also 10 Federal Reserve Board, 1923, pp. 296–297.

be collected consistently with the legal rights of the drawee without paying an exchange charge. Within these limits federal reserve banks have ordinarily the same right to present a check to the drawee bank for payment over the counter, as any other bank, state or national, would have. . . .

"The findings of fact negative the charges of wrongful intent and of coercion. The federal reserve bank has formally declared that it is willing, when presenting checks, to accept in payment a draft of the drawee bank upon its Atlanta correspondent or a draft upon any other solvent bank, if collectible at par. Country banks are not entitled to protection against legitimate competition. Their loss here shown is of the kind to which business concerns are commonly subjected when improved facilities are introduced by others, or a more efficient competitor enters the field. It is *damnum absque injuria.*"

The decision must be regarded as a victory for the Federal Reserve Bank of Atlanta, and is important because it settles the question as to the right of a federal reserve bank to collect checks drawn upon a nonmember which refuses to remit at par. But the plaintiff banks were not completely defeated for they had induced the federal reserve bank to accept drafts upon correspondents instead of cash when checks were presented at the counter. The language of the Supreme Court decisions also threw some doubt upon the right of a reserve bank to insist upon payment of checks in actual cash in every case. But the plaintiffs lost completely on their contention that they should be permitted to make exchange charges in remitting to the federal reserve bank.

The Richmond Bank Case

The question at issue in the Richmond Bank case was quite different from that raised in the suits against the Federal Reserve Bank of Atlanta. The Richmond case raised the question as to whether the Federal Reserve Act *required* the federal reserve banks to establish a universal nation-wide system of par remittance. It also involved the constitutionality of a statute passed by the legislature of

North Carolina which gave banks in that state the privilege, under certain conditions, of paying checks presented at their counters by agents of the Federal Reserve Bank of Richmond in exchange drafts on correspondents instead of in cash.

The Federal Reserve Bank of Richmond, on November 15, 1920, put all of the North Carolina banks on the par list, and made presentation of checks at the counters of banks which refused to remit in full through the mails. Two days later a meeting of the North Carolina Bankers' Association was held at Greensboro to organize opposition to this action of the reserve bank. Through their efforts the North Carolina legislature passed a law on February 5, 1921, making it lawful for all banks and trust companies in the state to charge a fee of not more than 1/8 of 1 per cent on remittances covering checks. Section II of this law provided, "All checks drawn on said banks and trust companies shall, unless specified on the face thereof to the contrary by the maker or makers thereof, be payable at the option of the drawee bank in exchange drawn on reserve deposits of said bank, when such checks are presented by or through any Federal Reserve bank, post office, or express company, or any respective agents thereof." The Richmond Bank took the position that the law was unconstitutional and sent a letter to the North Carolina nonmember banks stating that, upon advice of counsel, it would continue its efforts to enforce par collection. The letter contains this paragraph:

"In the event you should not be willing to remit us AT PAR BY MAIL, we will be forced to present checks at your counter for payment IN CASH ONLY. Should payment in cash be refused, we will promptly return the checks to the banks from which we receive them, with a plain statement that the checks were presented by a personal representative of this Bank and payment in money refused, and a prompt notice of dishonor will be attached to the checks in lieu of formal protest. All such checks upon which payment has been refused will, in due

course, be returned to the drawee, YOUR CUSTOMER, who will then know you have refused to pay his check in money, in conformity with universal custom, and with requirement of law, as we believe. We will feel called upon to continue to do this as long as you make it necessary."

The tone of this letter was clearly belligerent and quite naturally intensified the opposition of the North Carolina bankers. When the banks refused to pay checks in cash and offered exchange drafts the federal reserve bank refused to accept the drafts and returned the checks dishonored.

The President of the North Carolina Bankers' Association advised the bankers to remit at par and offer no resistance.[9] In spite of his advice a number of the banks, on February 29, 1921, secured an injunction in the Superior Court of Union County restraining the Federal Reserve Bank of Richmond from returning as dishonored any checks drawn upon the plaintiff banks and presented at the counter by an agent of the federal reserve bank, where the plaintiffs had tendered in payment their exchange drafts. The Federal Reserve Bank of Richmond then discontinued the acceptance of checks which were drawn upon the plaintiff banks, but continued to accept for collection checks upon all other nonmember banks and to continue presentation at the counters of these banks where they refused to remit at par. As a result many more banks joined with the original plaintiffs to get the advantage of the injunction until approximately 270 banks had so joined.

The Federal Reserve Bank of Richmond attempted to secure a transfer of the case to the federal courts, but failed because it was decided that the sum involved was not large enough to give jurisdiction to the federal courts. The case went up to the Supreme Court of North Carolina which in May, 1922, unanimously reversed the lower state courts on the ground that the statute under which the in-

[9] *Journal A. B. A.*, Dec., 1920, p. 448.

junction was granted violated the Federal Constitution.[10] The court stated that the provision in the Federal Reserve Act forbidding the payment of exchange charges by federal reserve banks was a valid constitutional provision. The North Carolina statute giving power to state banks to remit in exchange for less than the face value of checks presented for payment was in direct conflict with the Federal Reserve Act. The court said, "In such a conflict of authority, the federal law is supreme," and also "No act of this state can authorize the drawee bank to pay less than the face amount of the check drawn upon it by its depositors or to remit its check in payment or pay for it otherwise than in legal tender." This statement apparently upheld the contention of the federal reserve bank that an exchange draft was not legal tender.

No state then, said the decision, could relieve a bank from the necessity of paying its checks in full across the counter, as North Carolina had tried to do. Neither could a state empower its banks to deduct exchange when remitting by drafts on correspondents. While the federal reserve bank could not require a nonmember to give it a draft for the full amount, it could refuse to receive one for less and was entitled to receive the full amount over the counter in cash. Finally, said the court, there was no evidence of coercion or that checks had been accumulated over a considerable length of time in order to ruin the nonmembers by demanding a large amount of cash. With regard to the assertion that the methods of the reserve bank would ultimately compel all checks to be collected through the federal reserve system the court said it was not concerned. Such a decision by a state court was indeed remarkable. The court should be commended for its independence in rendering an opinion which it must have known would be most unpopular.

[10] Farmers' and Merchants' Bank of Monroe v. Federal Reserve Bank of Richmond, Ninth Annual Report of the Federal Reserve Board, 1922, pp. 261–265; also *Fed. Res. Bull.*, June, 1922, pp. 701–703.

The state banks took the case on a writ of certiorari to the United States Supreme Court, and the result was awaited with much interest. The decision was announced on June 11, 1923. It reversed the decision of the Supreme Court of North Carolina, and upheld the constitutionality of the North Carolina statute.[11]

The argument that the North Carolina statute was unconstitutional was based by the attorneys for the Federal Reserve Bank of Richmond upon five contentions. The first of these was that the authorization for payment of checks by drafts on reserve deposits violated article 1, section 10, clause 1 of the Federal Constitution, which prohibits a state from making anything except gold and silver coin legal tender in payment of debts. Mr. Justice Brandeis, speaking for the court, denied the validity of this argument on the ground that the debt of the bank was solely to the depositor who had drawn the checks. The bank owed no debt to the holder of a check. Therefore, paying a check was not paying a debt, and the check need not be paid in gold or silver coin. There was nothing in the Federal Constitution to prevent the drawer assenting to the payment of a check in an exchange draft, and it was perfectly proper to presume such consent where the drawer had not specified to the contrary. The rights of the payee or the holder of the check were not violated since these persons take the check "subject to the construction and with rights conferred by the laws of North Carolina, the place of the bank's contract and of performance."

The second contention was that section 2 of the North Carolina statute violated the due process clause of the Federal Constitution. The Richmond Bank argued that the right to engage in the collection of checks was a valuable property right because the federal reserve bank might, if it so desired, obtain revenue from charges made for this

[11] Farmers' and Merchants' Bank of Monroe v. Federal Reserve Bank of Richmond, 262 U. S. 649 (1923); also 10 Federal Reserve Board, 1923, pp. 298–300.

service. To permit the payment of checks in exchange drafts with deduction for exchange deprived the federal reserve bank of liberty of contract and of an important branch of its business, since the collection of checks could not be conducted under such a limitation. But the Supreme Court refuted this argument by stating that in this respect "the statute is merely an exercise of the police power, by which the banking business is regulated for the purpose of protecting the public, and promoting the general welfare."

The third contention was that the North Carolina statute violated the equal protection clause of the Federal Constitution, for other banks than the federal reserve banks might demand payment in cash unless presentation was made through an express company or post office. But the court replied that a state might "direct its police regulations against what it deems an existing evil, without covering the whole field of abuses." Legislation might be directed solely and specifically against "a particular instrument of trade war," and the prohibition might be limited only to the conditions and concerns which the legislature believed were a menace to the public welfare. The North Carolina legislature was therefore upon sound ground in this respect.

The fourth and fifth contentions formed the basis for the strongest attack upon section 2 of the North Carolina statute. The first of these claimed that this statute conflicted with the Federal Reserve Act because it prevented the federal reserve banks from collecting checks upon banks which refused to remit at par. This argument rested upon the assumption that the Federal Reserve Bank of Richmond was *required* by law to receive for collection *any* check upon *any* North Carolina bank, if the check was payable upon presentation, and that the obligation extended to collection at par. But the court replied that nothing in the Federal Reserve Act *obliged* reserve banks to receive checks for collection. The Act was not compulsory but

merely permissive in this respect. Even if the reserve banks were compelled to collect checks for authorized depositors there was nothing in the Act requiring them to do so where the drawee bank refused to remit at par. The Court said, "There is surely nothing in the Act to indicate that reserve banks must undertake the collection of checks in cases where it is impossible to obtain payment except by incurring serious expense; as, in presenting checks by special messenger at a distant point." In addition, checks which the reserve banks may receive are limited to those "payable on presentation." This phrase, said the court, implied that such checks must be payable either in cash or in funds believed by the reserve bank to be the equivalent of cash. A check payable at the option of the drawee bank in an exchange draft on reserve deposits would, in the opinion of the court, seem to be not payable on presentation, and hence not eligible for receipt by the federal reserve banks.

Finally, it was claimed by the Federal Reserve Bank of Richmond that the North Carolina statute was in conflict with the Federal Reserve Act because its effect was to prevent the Federal Reserve Board from establishing a universal par clearance and collection system, a duty which the Board claimed had been imposed upon it by the Federal Reserve Act. The court, however, rejected this argument with finality. Mr. Justice Brandeis stated that there was nothing in the original Act or any amendment thereto which could possibly be construed as imposing upon the Federal Reserve Board the duty of creating a universal par clearance and collection system including all banks in the country whether member or nonmember. The only use of the word "par," he said, was in section 16 of the Act and the evidence was clear that the provisions in that section requiring the receipt of checks on deposit at par by the federal reserve banks had no application whatever to checks drawn on banks which were not members of the

federal reserve system. Furthermore, the Hardwick Amendment of June 21, 1917, which definitely permitted all banks, even member banks, to continue to make exchange charges against all other banks except the federal reserve banks, showed that it was not expected by Congress that the federal reserve banks would become the universal agency for collecting all checks at par. Had such intent been present, said the court, the Act would have been so framed as to make any exchange charge impossible. But, this Hardwick Amendment specifically retained for all banks so desiring, the right to make deductions in remitting for their own checks to banks other than the federal reserve banks.

That this decision was a disappointment to the officers of the federal reserve system is freely admitted by them. The campaign to force all banks in the country to remit at par had been based upon the belief that the federal reserve banks were only carrying out a duty imposed upon them by law. That particular justification for the campaign to enforce par remittance was removed by this decision, and the contention of the opponents of par remittance that the officers of the federal reserve banks were not required by law to force par remittance upon unwilling nonmember banks received the approval of the highest court of the land. Largely as a result of this decision the number of banks refusing to remit at par began to increase until nearly 4,000 now refuse to so remit. During the most successful period of the movement for par remittance almost all of the recalcitrant banks were located in the South. The years since this decision have witnessed increasing withdrawals from the par list in the Chicago, Minneapolis, and San Francisco districts. The establishment of a universal par remittance system received by this decision a decided setback.

Shortly after the decision in the North Carolina case the Federal Reserve Board revised its regulations dealing

with the clearing and collection of checks. The Board felt that since it had been determined that there was no obligation resting upon it to establish a universal par remittance system, and since the federal reserve banks could not pay exchange, certain changes in the methods of handling checks upon exchange charging banks were necessary. The Board therefore stated: [12]

> "It is clear that those nonmember banks which are unwilling to remit without deduction for checks drawn on themselves have no right to share in the advantages of the par collection system."

Section III of the revised regulations read in part as follows: [13]

> (c) No federal reserve bank shall receive on deposit or for collection any check drawn on any nonmember bank which refuses to remit at par in acceptable funds.
>
> (d) Whenever a federal reserve bank receives on deposit or for collection a check drawn by, indorsed by, or emanating from any nonmember bank which refuses to remit at par in acceptable funds, it shall make a charge for the service of collecting such checks of one tenth of 1 per cent, the minimum charge to be 10 cents for each item.

It was announced by the board that these regulations were to go into effect on August 15, 1923. The effect of the regulations would have been to exclude from the federal reserve check collection system all checks drawn on nonmember banks refusing to remit at par, and to handle checks drawn by, indorsed by, or emanating from such banks only at a certain charge for the service. So much protest was made against certain provisions of the regulations that the board decided to postpone the date upon which they were to go into effect.[14] The main objections that were raised had to do with section (d), quoted above,

[12] *Fed. Res. Bull.*, July, 1923, pp. 773–774.
[13] *Ibid.*, July, 1923, pp. 773–774.
[14] *Fed. Res. Bull.*, Aug., 1923, p. 877.

for a number of the officers of the federal reserve banks believed that it would not be desirable to charge for collecting checks drawn by nonmember nonremitting banks. A further objection raised was that the charge for the service was too large, as the minimum was ten cents for each item. Under these regulations a check drawn on a member bank but indorsed by a nonremitting nonmember bank would have been subject to this charge. This stipulation was attacked by the members of the Federal Advisory Council, because of possible undesirable effects upon member banks.[15] However, there was little objection to the decision to refuse to receive on deposit checks on nonmembers which could not be collected at par. Until the final decision was reached, the federal reserve banks refused to receive checks which were drawn on nonmember banks which refused to remit at par in acceptable funds.

THE CLAIBORNE-ADAMS PLAN

Meanwhile, a solution proposed by the opponents of par remittance was presented at a joint meeting of the Federal Reserve Board and a committee of governors of the federal reserve banks on August 1, 1923. The sponsors for this plan were Mr. Charles de B. Claiborne of New Orleans, chairman of the Committee of Five on Exchange of the American Bankers' Association, and Mr. L. R. Adams of Atlanta. This plan became known as the "Claiborne-Adams Check Collection Plan." It provided that each federal reserve bank was to receive on deposit at par from the member banks and nonmember clearing banks in that district for immediate credit and availability, checks which were payable in that district and which were drawn upon any bank which agreed to remit at par in funds acceptable to the federal reserve bank.

It will be seen at once that this plan would have done away in large part with the present scheme of "deferred

[15] *Ibid.*, October, 1923, p. 1089.

availability" under which checks deposited in the federal reserve banks cannot be subject to check or counted as reserves until a certain number of days as stated in the time schedule, have elapsed. The "deferred availability" system was created to abolish the old practice under which checks in transit were counted as reserves. The Claiborne-Adams plan retained, however, the "deferred availability" system with regard to checks drawn upon banks situated in another district than that of the federal reserve banks in which they deposited, and checks drawn upon banks both within and outside of the district which refused to remit at par. Checks drawn upon banks refusing to remit at par and upon banks outside of the district were to be received by the federal reserve banks as forwarding agents only and for deferred credit only. When such checks were sent to the drawee bank, this bank might remit to the federal reserve bank in an exchange draft covering the face value of the checks minus a deduction of not over ten cents for each $100 of checks, but in no case to be less than ten cents for any one remittance. This plan evaded the prohibition contained in the Hardwick amendment against the payment of exchange charges by the federal reserve banks, as it specified that the charge was not made against the federal reserve bank but against the bank for whom the federal reserve bank acted as forwarding agent. The result would have been that exchange charges deducted by drawee banks in remitting for checks sent to them by the federal reserve banks would have been passed on to the bank depositing the checks in the federal reserve bank. It should be clearly understood that under the proposed Claiborne-Adams plan all member banks would be permitted to make such deductions should they so desire on checks returned from a bank in another district. In short, this plan opened the door for a substantial abandonment of the par remittance system built up at so much expense and difficulty by the federal reserve banks.

The Claiborne-Adams plan was referred by the Federal Reserve Board to an advisory committee of the Governors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, and Chicago. This committee reported that it was unanimously opposed to the plan for the following reasons: (1) The granting of immediate credit on certain checks would reinstate one of the glaring faults of the old banking system in that it would build up an enormous fictitious reserve, adding probably $300,000,000 to the "float" and reducing the actual reserves to this extent; (2) annual exchange charges amounting to over $100,000,000 would again be imposed upon the business of the country; and (3) immediate credit would probably have to be given on the majority of checks—for example, a bank in the Cleveland district, instead of sending a check drawn on a bank in the Chicago district to the Federal Reserve Bank of Cleveland for collection, would send the check to a correspondent in the Chicago district and this correspondent could obtain immediate credit. This advisory committee recommended that the Federal Reserve Board should announce the rejection of the Claiborne-Adams plan as a solution. The committee also recommended, and the Federal Reserve Board so ordered, that any federal reserve bank which was still using any agent which was not a bank for the collection of checks should cease this practice at once.[16]

The matter of finding a satisfactory solution of the par remittance question was placed before the Federal Advisory Council, which met in Washington during September, 1923. Several of the governors and federal reserve agents were in Washington at this time, and a vigorous attempt was made to determine what the future policy of the federal reserve system should be. In its report, the Federal Advisory Council recommended the rejection of the Claiborne-Adams plan for the same reasons put forth by the advisory

[16] *Fed. Res. Bull.*, Nov., 1923, p. 1194.

committee of governors.[17] Those bankers supporting the Claiborne-Adams plan claim that "deferred availability" of checks under the federal reserve collection system prevents the system from actually being one of par collection, as the loss of the use of funds until the checks are collected acts as a charge upon the banks sending in the checks. This complaint has not sufficient merit to warrant serious attention, as the evils of "immediate availability" are well known.

That it was a very difficult matter to reach a decision is shown by the fact that not until May 9, 1924, was Regulation J, dealing with the clearing and collection of checks, issued in final form by the Federal Reserve Board. The Claiborne-Adams plan was not adopted. Paragraph 3 of Section III of the revised regulations merely stated that no federal reserve bank "shall receive on deposit or for collection any check drawn on any nonmember bank which cannot be collected at par in funds acceptable to the Federal Reserve Bank of the district in which such nonmember bank is located." One important change from the 1923 regulations should be noted. Paragraph (d) of Section III of the 1923 regulations, which provided for a charge by the federal reserve banks for handling checks drawn by, indorsed by, or emanating from nonremitting nonmember banks, did not appear in the new regulations. Apparently the objections to such charges were so vigorous that it was decided not to put them into effect at this time. Certain officers of the federal reserve system felt that such charges would drive the collection of a large number of checks out of the hands of the reserve banks and do more harm than good.

When the advocates of the Claiborne-Adams plan found that the Federal Reserve Board would not accept their recommendations they modified their scheme somewhat. The amended plan limited to a somewhat greater

[17] *Fed. Res. Bull.*, Oct., 1923, p. 1089.

extent the right to make exchange deductions in remitting to the federal reserve banks. The revision also stated that immediate credit need not be given on any check returned from another federal reserve district. This removed one of the objections raised by the Federal Reserve Advisory Council and the Board of Governors of the federal reserve banks. But even with these changes the plan did not win the support of the officers of the federal reserve system.

The Malloy Case

An interesting decision by the United States Supreme Court in 1924, known as the Malloy Case, revealed a difficulty in which a federal reserve bank might find itself as the result of the decision in the Richmond Par Collection case. The facts will not be recited here, but the decision of the court was to the effect that a federal reserve bank cannot legally accept anything but money as payment for a check forwarded to the drawee bank, without being held liable. Where the drawee bank remits to the reserve bank by a draft on another bank and this draft is not paid the payee of the check may ultimately secure compensation from the federal reserve bank. The dilemma in which this places the reserve bank may be evident when it is remembered that the Richmond Par Collection case decided that a bank might remit by an exchange draft where a state statute so permits. But under the Malloy decision if the federal reserve bank accepts this draft and the draft turns out to be worthless the federal reserve bank may ultimately be held liable for not having insisted on being paid in actual cash.[18] And yet under the Richmond Par Collection case the drawee bank cannot be compelled to pay in cash. Under these conditions what course should be followed by the federal reserve bank?

[18] Federal Reserve Bank of Richmond v. Malloy *et al.*, 264 U. S. 160 (1924).

The Pascagoula National Bank Case

After the decision in the North Carolina or Richmond Par Collection case the opponents of par collection resolved to restrict the par collection system still further. They claimed that nothing in the Federal Reserve Act required even member banks to remit at par, and they asserted that they would stop a federal reserve bank from receiving for collection any checks except those "payable upon presentation within its district." They also hoped to force the federal reserve banks to give immediate credit for those checks which the Federal Reserve Act says the reserve banks "shall receive on deposit at par." It was some time before a member bank willing to become the plaintiff in such a suit could be found. The bank finally selected to test the powers of the federal reserve banks on these questions was the Pascagoula National Bank of Pascagoula and Moss Point, Mississippi. In August, 1924, this bank entered suit in the United States District Court for the Northern District of Georgia against the Federal Reserve Bank of Atlanta, the Federal Reserve Agent at Atlanta, and the Federal Reserve Board.[19] The defendents were charged with ignoring and violating certain provisions of the Federal Reserve Act. The plaintiff asked for an injunction to:

1. Require the Federal Reserve Bank of Atlanta to give immediate credit and availability to the plaintiff for all deposits of checks and drafts on other banks in the Atlanta district regardless of the distance of the drawee bank from Atlanta.

2. Permit the plaintiff bank to make deductions in remitting for checks and drafts drawn upon it and presented for payment by or through the Federal Reserve Bank of Atlanta.

3. Prohibit the Federal Reserve Bank of Atlanta from handling checks for any banks other than its own members, and for its own members any checks which were

[19] *Fed. Res. Bull.,* Feb., 1925, p. 100.

not payable within the Atlanta district. It also asked that the federal reserve agent and the Federal Reserve Bank of Atlanta be enjoined from enforcing Regulation J of the Board's 1924 regulations.

The plaintiff further contended that the Hardwick Amendment preventing banks from deducting exchange charges in remitting to reserve banks was unconstitutional under the Fifth Amendment since it deprived the remitting bank of property without due process of law. Finally, the Pascagoula National Bank asked for damages from the Atlanta bank to the amount of exchange charges and interest of which it alleged it had been illegally deprived.

A preliminary injunction was denied by the District Court on October 3, 1924. The Court also dismissed the Federal Reserve Board from the suit on the ground that under section 51 of the Judicial Code it could not be sued in the Northern District of Georgia without its consent. After arguments on the merits of the case Justice Sibley on December 29, 1924, dismissed the complaint. He disposed of the plaintiff's contentions in the following order: [20]

I. The plaintiff stated that section 16 of the Federal Reserve Act required the federal reserve banks to receive checks from member banks "on deposit at par." But when, under Regulation J the reserve banks deferred availability according to a time schedule on such checks, they were not being received "at par." The Act itself said nothing about "deferred availability." Therefore the Act was being violated.

The court in dismissing this contention first argued that even under a general deposit, which did not exist here because the reserve banks acted mainly as collecting agencies, banks frequently would not permit deposits of checks to be drawn upon immediately. Otherwise the bank by honoring checks in advance of collection would be lend-

[20] 11 Fed. Res. Board, 1924, pp. 231–234; *Fed. Res. Bull.*, Feb., 1925, p. 100; also 3 Fed. (2nd series), p. 465.

ing money without interest. The time schedule for availability drawn up by the federal reserve banks would seem to be "ordinary prudent banking" practice because of the large float involved Furthermore, said the court, section 16 must be considered in relationship to sections 13 and 19 of the Act. Section 13 refers specifically to deposits for collection and requires nonmember clearing banks to keep sufficient balances to cover items in transit, "which is another way of saying that checks are not available credits while in transit." These deposits under section 19 constitute for member banks their required reserve and must be "actual net balances." The time schedule minimizes "accumulated disappointments" and "seems a very reasonable reconciliation of the requirements of section 16, that the checks be received on deposit in the reserve account, with that of section 19, that the reserves be actual net balances."

But does the fact that the federal reserve banks under Regulation J, Section 5, act only as collection agencies for the member banks in receiving such checks, giving credit according to the time schedule, conflict with the provision that they must be received "at par?" The court said it did not. While checks are at first received for collection only, yet when credit is given at the expiration of the period fixed by the schedule, whether returns from the check had been received or not, at that time the agency ceases, the check becomes the property of the bank and "the transaction ripens into a general deposit. The check is then 'received on deposit at par' as required by section 16."

II. The plaintiffs contended that they should be permitted to make deductions in remitting to the federal reserve banks for the following reasons:

(a) Section 16 of the Federal Reserve Act permits a member bank to charge actual expenses incurred in collecting and remitting funds or for exchange sold to its patrons. The charges made against patrons whose checks are collected through the federal reserve banks are to be

fixed by the Federal Reserve Board. But the Hardwick Amendment to section 13 reads:

> "Nothing in this *or any other section* of this act shall be construed as prohibiting member or nonmember banks from making *reasonable charges,* to be determined and regulated by the Federal Reserve Board, but in no case to exceed 10 cents per $100 or fraction thereof, based on the total of checks and drafts presented at any one time for collection or payment and remission therefor by exchange or otherwise; *but no such charges shall be made against the Federal reserve banks.*"

The last clause in italics was not in the amendment as originally introduced in Congress.[21] It was inserted later before the passage of the amendment, and was largely responsible for the entire par collection controversy.

The plaintiff alleged that the last clause in the Hardwick Amendment was in the nature of an exception which was wholly repugnant to the main clause preceding it and was therefore void, thus leaving unrestrained power to make exchange charges. Or, if the last clause was really a part of the whole then the two sections were so inconsistent that they could not govern, and section 16 mentioned above was the controlling law.

The court denied this. On the authority of the Richmond Bank case, it said, the right to make charges against other member and nonmember banks still exists. Such charges can be and are actually made by many banks against each other. It is only against the federal reserve banks that such charges cannot be made.

(b) The plaintiff asserted that exchange charges are actually not made against the federal reserve bank unless it is the lawful owner of the check. Where the reserve bank acts only as a collecting agent the charge is not against the bank but against the true owner and is to be passed back to him by the reserve bank. But the court held this argument to be fallacious. While the intent of the Hardwick Amendment as introduced was to wipe out par collection,

[21] Italics mine.

yet the addition to the last clause distinctly showed that Congress had no such desire. So far as the actual ownership of the check was concerned, that made no difference.

III. The plaintiff also argued that the Federal Reserve Bank of Atlanta could not handle for collection or receive on deposit checks drawn on the plaintiff coming to the Atlanta bank from outside the Atlanta district. Nor should it be allowed to handle, even for its own member banks, checks which were not payable in the Atlanta district.

The court disposed of this claim by saying that the powers to which objection was raised were clearly granted to the federal reserve bank by section 13 of the Act which reads that a federal reserve bank may "solely for the purpose of exchange or collection, receive from other reserve banks . . . checks and drafts payable upon presentation within its district." All reserve banks may receive from their members and nonmember clearing banks maintaining clearing balances "checks and drafts payable upon presentation" at any place. The Atlanta bank had handled no such checks on its members unless they had been sent in by another reserve bank or by the members of another reserve bank by the latter's authority and for its account. Checks received from a member in another district under these circumstances were in effect received from the reserve bank itself.

IV. Finally, a constitutional objection was raised to par collection. It was asserted that inability to make exchange deductions was depriving a bank of property without due process of law, a procedure forbidden the federal government by the Fifth Amendment to the Constitution. The court denied this stating:

"Complainant may refuse to pay otherwise than in cash over its counter, according to the common law, as, on the other hand, the reserve bank may insist on that sort of payment. What is lost is the right to *agree* on a compensation for a more

convenient payment by draft on more accessible reserves when both parties are *willing* so to agree. That the State, having power over the State banker and his business, may regulate his method of receiving and paying out his deposits was ruled in Farmers and Merchants Bank of Monroe v. Federal Reserve Bank of Richmond, 262 U. S. 649. A similar power must be recognized in the United States to regulate the banking in the Federal Reserve System. Complainant being a national bank, chartered to do its business under the Federal laws, can not complain that those laws are not, or do not remain, such as it would prefer. It is not compelled to do anything without compensation. It is simply told that *if* it does the thing in question it must be done without compensation. Noble State Bank v. Haskell 219 U. S. 575."

This decision of the lower federal court is given at some length because its arguments were accepted practically without criticism or discussion by the Circuit Court of Appeals and United States Supreme Court. The only question discussed at length in the higher courts was that of immediate availability. Little was added on that point.

The plaintiffs appealed the case directly to the United States Supreme Court on the ground that a constitutional question was involved. The Supreme Court, however, did not believe that the constitutional question was sufficiently important to justify such a direct appeal. Accordingly, on November 30, 1925, it issued an order transferring the case to the Circuit Court of Appeals for the Fifth Circuit. This action was understood to signify that compulsory par remittance for members was constitutional.[22]

The case was argued before the Circuit Court, January 20 and 21, 1926. The decision was announced February 11, 1926. It supported the lower court on all points. The court, however, was not unanimous, dividing 2 to 1. Justices Walker and Bryan composed the majority. Justice Foster dissented in a very interesting opinion.[23]

[22] *Fed. Res. Bull.*, March, 1926, pp. 174–175; Annual Report of the Federal Reserve Board for 1925, pp. 34–35; 278–281.

[23] *Ibid.*

The only question discussed by the majority of the court was that of immediate availability. The court held that section 16 of the Federal Reserve Act specified only the amount of credit to be given and not the time of giving it. In the absence of statutory provisions the time at which credit should be given is determined by agreement, express or implied, between the parties. The bank is not required to give immediate credit if the customer has notice that such credit will not be given, and it is the custom of many banks not to do so. The question involved must be considered in the light of custom. It cannot be said that banks receiving checks for deferred availability are not actually receiving them on deposit. The court said:

> "If that provision has the meaning attributed to it in behalf of the appellant, practically it has the effect of requiring a reserve bank to buy from member banks checks on its depositors and to pay in cash therefor the amount they call for, or to lend without interest that amount on such checks for whatever time may elapse between the bank's receipt of them and the presentation of them to the drawees for payment, the obligation incurred by the member bank in such a transaction being to repay to the reserve bank the amount of checks not paid by the drawees. That the lawmakers did not intend the provision in question to have that effect is persuasively indicated by other provisions of the Federal reserve act."

The last sentence has reference to the fact that a member bank's checking account is also, under section 19 of the Act, a reserve balance. This, under the reserve requirements, must be "an actual net balance." This it cannot be, said the court, if part of it is represented by uncollected checks. Such was not the intention of Congress. Nothing in the Federal Reserve Act authorizes a federal reserve bank to invest its funds in uncollected checks on other banks presented by a member bank. Under the plaintiff's contention a reserve bank would constantly have many millions of its resources invested in noninterest

bearing paper in transit. Therefore, concluded the court, immediate availability is not required.

With regard to other points involved all the court had to say was that in view of the "unequivocal language" of section 13 and the decisions of the Supreme Court in the Atlanta and Richmond cases "it would be superfluous to add anything to what was said in the opinion rendered by the district judge in support of the conclusion that appellant was not entitled to make exchange or remitting charges on checks on itself received from appellee, whether appellee was the owner of those checks or held them for collection pursuant to authority—conferred by the Federal reserve act." The decree of the lower court was affirmed without exception on any point.

Mr. Justice Foster, in dissenting, claimed that section 16 made it compulsory on federal reserve banks to receive deposits of checks "at par." Section 13 said reserve banks might receive such checks but did not specify that they must be received "at par." Regulation J, however, defers availability on checks received under both sections. This practice, he said, plainly violated section 16 for "receiving checks for collection is not receiving them on deposit" as required by that section of the Act.

It was idle, he continued, to assert that immediate credit would compel the federal reserve banks to lend money without interest. It would be merely a matter of bookkeeping. If the reserve banks applied clearing house methods, as authorized, most of the items could be handled in the bank. The danger of loss from immediate credit if the checks were not paid was infinitesimal. The reserve banks were sufficiently protected. If the check was not paid it could be charged against the member bank's reserve deposit. If the deposit was thus drawn below the reserve percentage required the penalty provided by the Act could be enforced. Immediate credit is not required in case of the doubtful solvency of the depositor or payee or a check

of questionable character. But, said Judge Foster, these are exceptions.

Furthermore, read the dissenting opinion, if it is stated that sections 13 and 16 construed together give discretion to the reserve bank to receive checks merely for collection, then the reserve bank is in a dilemma. For a charge made for payment for such checks is not a charge against the reserve banks of the type forbidden by the last clause of the Hardwick Amendment. The federal reserve bank must either give immediate credit or permit deductions for exchange. It cannot under the law refuse to do both. If the checks are received on deposit they must be given immediate availability, otherwise they are not received "at par," as required by section 16. If they are merely received for collection, deductions in remitting for them are not made against the federal reserve bank, but against the actual owner.

But it was argued that the federal reserve banks had to credit the full amount when collected. Therefore the charge would ultimately have to be paid by them. Judge Foster denied this, and quoted from the definition of "par clearance" by the Supreme Court in the Richmond case to prove his point. In conclusion, nothing in either section 13 or 16 requires such credit.

It cannot be denied that there is force in the dissenting opinion. But the majority held otherwise. The Pascagoula National Bank at once endeavored to have the United States Supreme Court call the case up for review on a writ of certiorari. The court on June 7, 1926, refused to do so, and the fight was over.

The San Francisco Par Collection Case

The Federal Reserve Banks of Richmond and Atlanta were not the only reserve banks to encounter legal resistance to par collection. The San Francisco Bank also found itself involved in court proceedings when the Brookings State

Bank of Brookings, Oregon, secured, late in 1921, an injunction in the United States District Court for Oregon temporarily restraining the San Francisco Bank and its Portland branch from using certain methods to enforce par remittance. Judge Woolverton, after further hearings, made this preliminary injunction permanent in June, 1922.[24] The judge ruled that a federal reserve bank may not coerce a nonmember bank in order to force it to remit at par. According to the court, the San Francisco Bank had been guilty of coercion.

It seems that the Brookings bank, a bank with only \$15,000 capital, was located in a town with no express service and when it refused to remit in full the San Francisco bank maintained an agent in Brookings for a year and collected something like \$108,000 over the counter at an expense of \$3,500 to the reserve bank. Upon the protest of the Brookings bank this agent was withdrawn and the reserve bank began sending checks and drafts direct to the Brookings bank, requesting that they be paid at par in exchange on Portland or San Francisco. Checks so forwarded were indorsed "Pay to Brookings State Bank for collection only and remittance in full without deduction for exchange or collection charges." This would have made the Brookings bank an agent in collecting on itself. Checks so forwarded were returned, however, by the Brookings bank without payment. The Brookings bank also refused to have these checks protested. The reserve bank returned these checks to the banks which had deposited them and informed these banks that they must look to the Brookings bank for the amount involved. The preliminary injunction restrained the reserve bank from sending the letters informing the banks that they must collect from the Brookings bank themselves.

This injunction was made permanent on the ground

[24] Brookings State Bank v. Federal Reserve Bank of San Francisco, 281 Fed. 222 (1922); also 9 Fed. Res. Board, 1922, p. 265.

that the Brookings bank was not called upon to remit in the manner demanded by the reserve bank, and that returning these checks was not tantamount to dishonor. If the Brookings bank had done as requested by the reserve bank it would have been its own agent in causing protest to be made for non-payment. This, the court said, could not be compelled by law, and the actions of the reserve bank, viewed as a whole, amounted to coercion. No injunction was issued regarding the agent at Brookings as he was removed, but the court might have enjoined collection in this manner for it said that the reserve bank had no right to accumulate checks and present them over the counter, as this savored of coercion. The court quoted the first decision of the United States Supreme Court in the Atlanta case as authority for its contention.

After the injunction was made permanent the Brookings bank entered suit against the Federal Reserve bank of San Francisco for damages. It was not until June 9, 1925, that a verdict was reached. The jury awarded the Brookings bank $1 actual damages and $17,500 punitive damages. Judgment was rendered accordingly. The reserve bank appealed to the United States Circuit Court of Appeals, but the case was settled out of Court before it came up on appeal.[25]

The Cleveland Bank Case

A similar result was reached in the suit of the Farmers and Merchants Bank of Catlettsburg, Kentucky against the Federal Reserve Bank of Cleveland. After the decision of the United States Supreme Court in the first Atlanta case this Kentucky bank secured in 1921 a temporary restraining order in the state courts against the methods of the Cleveland Bank in presenting checks. The defendant secured the removal of the case to the United States District court, where late in 1922 an injunction was issued restraining the Federal Reserve Bank of Cleveland from the use

[25] 12 Fed. Res. Board, 1925, pp. 34–35.

of oppressive methods in the enforcement of par remittanc.[26] The facts in this case are very interesting. It seems quite clear that the agent used by the reserve bank to make collection at the counter of the Kentucky bank showed far more zeal than wisdom in his efforts to make collection at the counter obnoxious to the Kentucky bank.

Following this injunction the Kentucky bank brought suit against the Federal Reserve Bank of Cleveland for damages. This case, however, like the case against the San Francisco Bank was settled out of Court in 1925.[27]

These cases differ from the first Atlanta cases in that the Federal Reserve Bank of Atlanta was not proved guilty of coercion. Whether the findings of guilt by the lower federal courts in the San Francisco and Cleveland cases would have been supported by the higher federal courts will never be known.

The Minneapolis Par Collection Damage Case

Another bank to institute a damage suit against the federal reserve bank in its district was the First State Bank of Hugo, Minnesota. In 1925 this nonmember bank brought action against the Federal Reserve Bank of Minneapolis for damages as a result of being forced to remit at par from 1920 to 1924. The plaintiff claimed it had been forced on the par list through coercion, the coercion consisting of the maintenance of an agent who presented checks at the counter for payment.

In the lower state courts the jury gave a verdict for the plaintiff, but on June 8, 1928 the Supreme Court of Minnesota reversed the decision of the lower court and gave judgment for the Federal Reserve Bank of Minneapolis. The court said there was no evidence justifying the jury in finding that there was coercion and directed a verdict for

[26] Farmers and Merchants Bank of Catlettsburg, Kentucky v. the Federal Reserve Bank of Cleveland, 286 Fed. 160 (1922); also *Fed. Res. Bull.*, Dec., 1922; also 9 Fed. Res. Board, 1922, p. 265.

[27] 12 Fed. Res. Board, 1925, pp. 34–35.

the defendant. Whether the case will be appealed is not yet certain.[28]

Another suit almost developed in Nebraska against the Federal Reserve Bank of Kansas City and its Omaha branch. The suit was avoided by the removal of the collecting agents and the removal of the protesting banks from the par list, whereupon the Federal Reserve Bank of Kansas City ceased handling their checks.

Conclusion

The opponents of par collection have succeeded in forcing the federal reserve banks to abandon the compulsory methods so much in vogue during 1919 and 1920. The reserve banks also abandoned the practice of using agents other than banks in making collections. They have also ceased handling checks on nonmembers which do not wish to remit at par. They have not been upheld in their contention that the law compelled them to establish nation-wide par remittance. On these points the opponents of par collection have come off victorious. On the other hand the federal reserve banks have been upheld in compelling remittance in full from all member banks, in handling checks drawn on remitting nonmembers, in deferring availability on the proceeds of checks, and in their claim that they were not guilty of coercion. The United States Supreme Court never had the opportunity of passing on the Cleveland and San Francisco cases so it is impossible to say whether these reserve banks were guilty of coercive methods. At any rate, the dream of a universal nation-wide par collection system has been shattered.

The opponents of par collection have, it is true, been partly successful. Does this mean that their position is tenable? Hardly, for few economists to-day believe that there is any justification for the deduction of exchange by a

[28] *Fed. Res. Bull.*, July, 1928, pp. 517–519.

drawee bank in remitting for checks. Where remittance involves expense the proper person to bear this expense is the depositor who draws the check. The burden should not fall upon the holder of the check. But exchange-charging banks claim that competition for accounts renders it almost impossible to make the drawer of the check pay this charge. If one bank tries it, the depositor may transfer his account to a bank which performs the service for nothing. These banks also claim that for the same reason it is impossible to require the depositor to maintain a balance large enough to offset the expense in paying the checks the depositor sends out of town. But inability to place the charge where it belongs does not justify the attempt to collect from some one else. Whatever loss is involved should be classed as one of the costs which competition forces banks to assume. Furthermore, the development of the federal reserve collection system has reduced the expense in the transmission of funds to a very small sum.

The increase in withdrawals from the par list since the federal reserve banks abandoned their policy of compulsion is disturbing, although 85 per cent of all banks in the country still remit at par. An annoying feature is that the present situation requires the existence of two collection systems, one under the federal reserve banks, and the other outside of the federal reserve system for collecting checks drawn on nonremitting banks. If these exchange-charging banks could not collect checks on so many other banks at par, there would be little or no profit in it for them. Most of them are able, through their correspondents who are members of the federal reserve collection system, to collect at par on all banks so remitting.

At the risk of repetition certain facts will be summarized. All member banks have remitted to the federal reserve banks at par since July, 1916. At the end of 1927 there were 9,000 such banks. The high point in the number of nonmember banks so remitting was reached Novem-

ber 15, 1920, at which time 19,188 nonmembers were so remitting. The number of nonremitting nonmember banks dropped by January 15, 1921, to 1,705, exclusive of mutual savings banks and unincorporated banks. These banks were distributed by districts as follows: Richmond 339; Atlanta 1,178; and St. Louis 188. The other districts were all par. Withdrawals from the par list, bank failures, mergers, and consolidations decreased the number of remitting nonmembers to about 13,000 by May of 1926. The number of banks refusing so to remit May 31, 1928, was 3,916.[29] Distributed by districts they were as follows: Cleveland 10; Richmond 580; Atlanta 1,010; Chicago 198; St. Louis 461; Minneapolis 1,127; Kansas City 272; Dallas 200; and San Francisco 58. All banks in the Boston, Philadelphia, and New York districts still remit at par. Outside of those districts the only states in which all banks remit in full are Ohio, California, Utah, and Nevada. Thus the opposition which was at one time said to center in a few recalcitrant Southern states is seen to have been really nation-wide, with the exception of three Eastern districts. The opposition has been greatest in the South, the Middle West, and the Northwest. It is clear that many banks went on the par list only because of the use of forceful methods by the federal reserve banks.

This brings us to the question whether anything further should be done to bring nearer to fulfillment the universal nation-wide collection system which was so close to actual realization in 1921. The fact that checks on approximately 4,000 banks cannot be collected through the federal reserve banks is a nuisance, to say the least. For a time it was thought that the commercial interests of the country might be able to persuade banks to remit at par. The National Association of Credit Men also endeavored to bring about universal par remittance by showing its effect upon the efficiency of business transactions. Several thou-

[29] *Fed. Res. Bull.*, July, 1928, p. 535.

sand banks, however, still refuse to abandon exchange charges and the situation shows little sign of improving.

Some authorities favor an amendment to the Federal Reserve Act making par remittance to the federal reserve banks compulsory for all nonmember banks.[30] But such a step would seem to be unwise at this time for two reasons. First, such an amendment is of doubtful constitutionality. Second, as a matter of policy its expediency is questionable.

That the constitutionality of such an amendment would be immediately tested is certain. Such a suit would involve not only the federal law, but also the laws passed in 1920 and 1921 by the legislatures of South Dakota and seven southern states, which gave the state banks the right to charge exchange. It is not at all certain that the United States Supreme Court would uphold this type of compulsion on nonmembers. The writer believes it to be a more drastic law than that taxing the state bank notes out of existence.

Laying aside the question of constitutionality, serious objections arise to such a course when looked at from the point of view of federal reserve policy. Would it be wise to stir up again the feelings of intense opposition which existed during the height of the campaign of force carried on by the federal reserve banks during 1919 and 1920? The amendment would certainly do so. This controversy has been one of the bitterest in all the banking history of the United States. It has created much ill feeling against the federal reserve banks. It has kept many state banks out of the federal reserve system. It has led others to withdraw from membership.[31]

30-In his recent book, *Clearing and Collection of Checks,* Dr. Walter E. Spahr favors such compulsion. He says, "A simple solution to the problem would be to pass a Federal law making the system compulsory for all banks." (page 578) In another place he says, "This measure would be no more drastic than was the measure taxing state bank notes out of existence in 1865." (page 278).

31 For an excellent account of the development of the par collection

(Continued On Next Page)

There is no workable solution in sight at present. Most remedies so far proposed would give rise to a situation fraught with controversy and bitterness. We have had enough of that for a while. The procedure most advisable would be to let the matter rest as it is, leaving it to the passage of time to convert the exchange charging banks so that universal par remittance may become a reality.[32]

system and the controversy it aroused see W. E. Spahr, *The Clearing and Collection of Checks*, Bankers Publishing Co., N. Y., 1926, pp. 164–290. Also see Willis and Steiner, *Federal Reserve Banking Practice*, D. Appleton & Co., N. Y., 1926, pp. 576–615.

[32] Some of the material in the preceding two chapters is adapted from two articles by the present writer: "The Par Remittance Controversy," *American Economic Review*, December, 1924, pp. 629–48, and "The End of The Par Collection Litigation," *American Economic Review*, December, 1926, pp. 610–21.

CHAPTER XV

STATE BANKS AND BRANCH BANKING UNDER THE FEDERAL RESERVE SYSTEM

THE rapid growth of branch banking in this country during recent years brought a difficult problem before the Federal Reserve Board. In 1905 only eighty-six banks in the entire country were operating branches. Ten years later the number had grown to 260. Today nearly 800 banks in the entire country maintain approximately 3000 branches or additional offices. Over two-thirds of all these branches belong to banks which are members of the federal reserve system.[1]

The problem confronting the Federal Reserve Board was that of deciding to what extent members of the federal reserve system should be permitted to engage in branch banking. How the development of branch banking became a question of importance in the administration of the system may be shown by the following table: [2]

[1] The most recent study on branch banking is that of Shirley D. Southworth. His volume, *Branch Banking in the United States,* was published by McGraw-Hill, of New York City, in 1928. The present writer had prepared this chapter on branch banking before the appearance of Professor Southworth's book and has not had the opportunity of making comparisons with that work.

[2] *Fed. Res. Bull.*, Dec., 1924, p. 935; *Ibid.*, June, 1926, pp. 407–408; *Ibid.*, May, 1927, pp. 315–318, 384–389.

MEMBER BANK BRANCHES OR OFFICES IN OPERATION

	National Bank Branches		Branches Maintained by State Banks which are now Members	
	In home city	Outside home city	In home city	Outside home city
1905	3	4	58	27
1910	6	6	115	43
1914	11	7	196	55
1916	23	16	236	65
1918	24	18	289	82
1920	38	18	443	104
1921	47	18	512	132
1922	115	21	647	209
1923	179	21	740	253
1924	227	21	807	287
1925	310	22	980	300
1926	377	27	1037	326

The total number of branches or offices in operation in the entire country during the same years is shown by the following table:

TOTAL NUMBER OF BRANCHES OR OFFICES

	Total branches or offices of all kinds	Total national bank branches or offices	Branches of state banks now members	Total non-member bank branches
1905	166	7	85	74
1910	329	12	158	159
1914	507	18	251	238
1916	626	39	301	286
1918	754	42	371	341
1920	1,052	56	547	449
1921	1,211	65	644	502
1922	1,602	136	856	610
1923	1,882	200	993	689
1924	2,095	248	1,094	753
1925	2,645	332	1,280	1,033
1926	2,777	404	1,363	1,010

These figures reveal clearly how rapid has been the increase in the number of branches in the country since the federal reserve banks opened their doors in 1914. Of the

2,900 branches in the country on February 25, 1927, approximately 400 were maintained by national banks and nearly 1,600 by state member banks. The number of national banks operating branches was at that time about 140 and of state member banks about 200. In March, 1927, the Bank of Italy, a state member bank, converted into a national bank. This conversion added nearly 300 branches to the number maintained by national banks and decreased by that amount the number maintained by state member banks. The Los Angeles—First National Trust and Savings Bank consolidation brought another hundred branches into the national system, so that on June 30, 1927, 152 national banks operated 721 branches and 186 state members operated 1,300 branches.

It was the fact that membership in the system is made up of two types of banks, national and state banks, that made a solution difficult. The right of national banks to open and maintain branches has been much more definitely restricted than the right of state member banks to do so. Although national banks exceeded the state bank members in numbers several times over the member state banks have operated during the last few years three or four times as many branches as the national banks. The rapid increase of branch banking by member banks was due more to extension of branch banking activities on the part of the member state banks than to the establishment of branches by national banks. Most national bank branches have originated through the conversion of state banks with branches into national banks. When this happened the national banks were permitted to retain and operate such branches. Branch banking by national banks showed little growth until after 1921. The increase after that year, until the nationalization of the Bank of Italy, was due almost entirely to the decision of the Comptroller of the Currency to permit the opening of additional home city agencies or offices for the receipt of deposits and cashing checks.

Competition between national and state banks has become increasingly strenuous during the last ten years. The desirability of operating under a national charter has become correspondingly less. The member state banks experienced less difficulty in opening new branches and national banks found it difficult to meet this type of competition. After the amendments of June 21, 1917, state banks were able to enter the system and retain privileges granted to them under their state charters and state law. Among these privileges possessed by the state banks in some states was that of branch banking. Therefore the Federal Reserve Board permitted many state banks with a large number of branches to enroll as members. But it added to an already serious situation in which one type of member in the system conducted its business under much more lenient restrictions than the other type. The question was frequently asked whether it was desirable to permit member state banks to engage in activities which were largely forbidden to the national banks. Could the number of national banks be maintained or increased if the state bank members enjoyed superior advantages? The problem was to equalize in some way the differences in the powers granted to these two types of members. Should not all members, whether state or national banks, be brought under one uniform group of requirements? Why should not state bank members be compelled to readjust their practices so that they no longer enjoyed advantages denied to the national banks? With regard to branch banking a great inequality was present in the operation of out-of-town branches. Only a dozen national banks had any out-of-town branches, secured only by taking over a state bank which maintained such branches. But over 50 member state banks had out-of-town branches and the number of such branches was increasing rapidly.

Before discussing the efforts of the Federal Reserve Board to solve this problem certain other facts should be

considered. Not all states permit branch banking. The following table reveals the legal status of branch banking in the United States: [3]

States which by statute prohibit branch banking (Total, 17)	States which by statute authorize branch banking (Total, 18)	States which do not specifically provide for branch banking by statute (Total, 13)
Alabama	Arizona	Iowa
Arkansas	California	Kansas
Colorado	Delaware	Kentucky
Connecticut	Georgia	Maryland
Florida	Louisiana	Montana
Idaho	Maine	Nebraska
Illinois	Massachusetts	New Hampshire
Indiana	Michigan	North Dakota
Minnesota	Mississippi	Oklahoma
Missouri	New Jersey [4]	South Dakota
Nevada	New York	Tennessee
New Mexico	North Carolina	Vermont
Oregon	Ohio	West Virginia
Texas	Pennsylvania	
Utah	Rhode Island	
Washington	South Carolina	
Wisconsin	Virginia	
	Wyoming	

Although the foregoing table states that South Carolina and Wyoming permit branches such permission is implied rather than definitely given in the law. Branches actually exist in some of the states which make no definite provision for them, by permission of the state banking authorities or by judicial decision. Maryland and Tennessee allow branches through administrative sanction. In New Hampshire one bank operates three branches outside of the home city under permission of the state authorities. Additional offices, but not completely functioning branches, are permissible in Kentucky through a decision of the Court of Appeals of that state.

We turn next to the question of how many states definitely permit *state wide* branch banking *by statute.* There

[3] *Fed. Res. Bull.*, Dec., 1924, p. 931; and June, 1926, pp. 401–408.

[4] Under limited conditions, made dependent upon the establishment of branches by national banks.

are nine such states. The number of branches existing in each on December 31, 1925, was as follows: [5]

	Number of state banks operating branches	Number of state bank branches	National banks operating branches	Number of National bank branches
California	81	593	19	47
North Carolina	37	66	2	3
Virginia	25	39	8	11
Maryland	28	89	4	6
Georgia	21	50	2	6
Rhode Island	8	25	0	0
South Carolina	6	15	2	4
Arizona	7	21	0	0
Delaware	5	15	0	0

The seven states which permit branch banking but restricted as to locality are:

	Number of state banks operating branches	Number of state bank branches	National banks operating branches	Number of National bank branches
New York	57	325	24	116
Ohio	49	209	3	4
Massachusetts	37	51	13	37
Louisiana	35	87	1	8
Maine	24	50	0	0
Tennessee	18	50	6	8
New Jersey	12	18	2	3

Five states permit branch offices or agencies, but not branches with all banking powers, as follows:

	Number of state banks operating offices	Number of state bank offices	Number of national bank offices	Number of additional national bank offices
Michigan	55	364	9	20
Pennsylvania	60	88	19	24
Mississippi	10	24	1	1
Kentucky	1	5	3	7
Nebraska	0		2	2

[5] *Fed. Res. Bull.*, June, 1926, pp. 405–406. Wyoming permits state wide branch banking by implication, but there are no branches in that state.

On December 31, 1926, the majority of the branch banks or additional offices in the country were located in the following states: [6]

	Number of banks operating branches or additional offices	Number of branches or additional offices
New York	105	507
California	88	668
Pennsylvania	83	127
Massachusetts	78	132
Michigan	68	397
Ohio	52	227
North Carolina	40	74
Louisiana	40	104
Virginia	37	59
Maryland	36	114
Maine	24	53
Tennessee	22	56
Georgia	22	38
New Jersey	13	20
Total	708	2576

Out of the total of 789 banks operating branches in this country on December 31, 1926, it is found that all but 81 of them are in the 14 states just listed.[7] Of 2,777 branches or offices in the country on that same date all but 201 of them were in the same states. The six leading states, New York, California, Pennsylvania, Massachusetts, Michigan, and Ohio, by themselves account for two-thirds of all the branch banking in the country.

While branch banking is growing in importance it should be pointed out, that only about 800 of the 26,000 banks in this country have as yet opened branches or additional offices. The largest branch banking institution in the country to-day is the Bank of Italy in California with approximately 300 branches. It is in that state that branch banking has shown its greatest development, 50 per cent of all banking offices being branches. In Michigan and

[6] *Fed, Res. Bull.,* May, 1927, p. 386.
[7] *Fed. Res. Bull.,* May, 1927, p. 386.

New York approximately one-third of all banking offices are branches.

To summarize, only about 140 of the 7,700 national banks have branches, and only thirteen of these have branches outside of the home city of the parent bank. About 200 of the 1,250 member state banks have branches and fifty-five of these have branches outside of the home city. A greater discrepancy comes with regard to the total number of branches operated by each class. Before the nationalization of the Bank of Italy the national banks had 400 branches, only twenty-seven of which were outside of the home city. Of the twenty-seven out-of-town branches, eight were in Louisiana, eight in California, three in Wisconsin, two in New Jersey and one each in Georgia, Virginia, Mississippi, and Oregon. But the member state banks operated approximately 1,600 branches, 300 of which were outside of the home city. Of the approximately 2,800 branches in the country on December 31, 1926, nearly one-half were branches of member state banks while slightly more than one-seventh were national bank branches. One of the outstanding facts was that on that date nearly two-thirds of all the branches or additional offices in the country belonged to member banks.

Development of Federal Reserve Branch Banking Policy

Within a year after the opening of the federal reserve banks the Federal Reserve Board is found urging greater branch bank privileges for national banks.[8] In 1916 the Board drafted a bill the object of which was to permit national banks with a capital and surplus of $1,000,000 in cities of 100,000 or over to establish branches within the corporate limits of the city where the bank was located and under certain restrictions in the county or within twenty-five miles of the city of the home office. The bill was passed

[8] 2 Fed. Res. Board, 1915, p. 22.

by the Senate but failed to secure the approval of the House. In its 1918 and 1919 reports and again in its 1922 report the Board renewed its recommendations, commenting upon the fact that national banks were finding it increasingly difficult to meet the competition of state banks with branches and that the proper development of the federal reserve system required the coördination of the powers of all member banks.[9]

In 1919 the Senate passed a bill authorizing national banks with a capital of $1,000,000 or over in cities of 500,000 or more population to establish not more than ten branches within the home city of the parent bank, provided state law gave similar privileges to the state banking institutions. The House again refused to pass the bill.

During the years in which the Board was making these recommendations the member state banks were continuously expanding their branches. It was true that about one-half of the member state banks were located in states which prohibited branch banking. But those member state banks which could under state law establish branches were opening new branches rapidly and the board remarked in its report for 1922 that the movement "had gone so far in a few states, notably California, and in a few large cities, including New York, Cleveland, and Detroit, as to reduce greatly the number of national banks."[10] The Board further stated that the action of the Comptroller of the Currency in 1922 permitting new national bank offices did "not meet the situation in California, and does not fully meet it in the cities mentioned," and that "an amendment to the national banking act allowing national banks the same privilege given to state banks in states where branch banking is permitted is much to be desired."

In its 1923 report the Board expressed the hope that it could "by administrative measure find some reasonable

[9] 5 Fed. Res. Board, 1918, p. 83; 6 Fed. Res. Board, 1919, p. 64.
[10] 9 Fed. Res. Board, 1922, p. 5.

method of harmonizing existing differences of interest of state and national banks in the matter of branch banking, and thus lay the basis for a policy which will result in shaping the development and practice of branch banking in the United States along useful and serviceable lines." [11]

Policy of the Board Before November 1923

During the last few years nearly two-thirds of all the branches in the United States have been branches of member banks. It was obvious, therefore, that the attitude of the Board would be of great importance in the further development of branch banking. Member state banks were permitted to retain their branches when joining the system and to add new ones after they had become members because under the amendments of June 21, 1917, these banks could exercise the charter and statutory rights given to them under state law. This was construed as granting them the right to engage in branch banking after enrollment in the system. The Board, however, reserved the right to pass on the question as to whether member state banks should establish additional branches.

Every application for permission to establish a new branch was considered on its merits, attention being given to the public convenience, and to the ability of the parent bank to organize the branch and properly care for the new business. Where there was any question that additional offices might impair the solvency or liquidity of the parent bank, approval was withheld. The facts considered were: [12]

1. The rate of expansion of the branch system.
2. Coördination of branches already acquired.
3. Head office control, supervision, and personnel.
4. Affiliation with outside corporations.
5. Relation of capital and surplus to deposit liabilities, especially in rapidly expanding branch systems.

[11] 10 Fed. Res. Board, 1923, p. 48.
[12] *Fed. Res. Bull.*, Dec., 1924, p. 926.

6. Methods of acquiring branches.
7. Local conditions and needs.

The Board approved the opening of additional offices not vested with the power to make loans rather freely unless such offices might impair the capital of the parent. It reserved the right to reconsider the case where these offices later wished to exercise all banking functions. Although the Board did not require simultaneous examinations of head offices and branches, yet if there was any evidence of inability on the part of the state authorities to conduct proper examinations of branch bank systems, the opening of additional branches was disapproved. For even though the parent bank was a member of the system the responsibility for adequate examinations must be assumed primarily by the state banking authorities.[13]

Branch Banking Resolution of November 7, 1923

A committee which had been appointed by the Federal Reserve Board to study the branch banking problem rendered its report November 7, 1923. The report was not unanimous, there being a vigorously dissenting minority which did not favor the restrictions on branch banking

[13] *Fed. Res. Bull.*, Dec., 1924, p. 926. In their book on *"Federal Reserve Banking Practice,"* Willis and Steiner refer to a "feud" which they assert sprang up between the Board and the Comptroller because from 1922 on the Board attempted to restrict the establishment of branches by banks already in the system and lop branches off of those coming in while the Comptroller endeavored to increase the number of national bank branches. To the authors this is a "wholly ridiculous position," which they state was largely remedied by the decision in the St. Louis case which "was obviously a severe defeat for the Comptroller." (p. 744). Granting that the authors are speaking from knowledge gained from intimate contact with the federal reserve system, the present writer cannot see where there was any "ridiculous" difference in policy. The Board was endeavoring to equalize the position of the two types of members by restricting state bank branches. On this point the Comptroller agreed with them, at least in his published statements. The Comptroller wished to gain wider branch banking privileges for the national banks. But so did the Federal Reserve Board. What, then, is "ridiculous" about that? Furthermore, is it quite certain that the decision in the St. Louis case was "obviously a severe defeat for the Comptroller?" (See his statement in *Fed. Res. Bull.*, April, 1924, p. 284).

recommended by the majority. The majority stated that it had tried to reach a decision which would prevent the further development of unequal branch banking privileges between the state members and national banks, so that the activities of the state members should not continue to endanger the existence of the national banks. "No bank, national or state," said the committee, "which was not willing to waive any privileges granted under state laws that were found to be inconsistent with the purposes of the Federal reserve system should enter or remain in the system, and it was the duty of the Federal Reserve Board to prescribe conditions under which banks might secure the compensating advantages of membership in the system." An announcement of policy upon this question was necessary if the board was to be fair to members so that they would not without warning engage in a course "unwittingly and innocently," which might "subsequently meet with criticism and disapproval of the board."

Accordingly the Board by a majority vote adopted a resolution embodying the following points:

1. All state banks entering the system must agree to establish no branches without the permission of the Federal Reserve Board.
2. As a general principle, state banks with branches or offices outside the limits of the home city or territory "contiguous thereto" should not be admitted to the system unless they relinquished such branches.
3. As a general principle, banks which were already members of the system should not be permitted to establish or maintain branches of offices outside of the home city or territory contiguous thereto.[14]
4. Branches or offices established prior to February 1, 1924, either by member banks or banks subsequently

[14] "Contiguous territory" was defined by the Board as meaning a city or town whose corporate limits coincided at some point with the corporate limits of the city or town in which the parent bank was located.

applying for membership were not to be affected by this resolution.

Although several members of the Board, who favored a greater extension of branch banking, voted against the resolution it became the policy of the Board. It can readily be seen that this resolution marked a decided change in attitude from that held up to 1922 when the Board gave permission rather freely to establish out-of-town branches.

Several banks at once requested the Board's approval of a plan to establish branches from time to time in accordance with a general plan for branch banking development. But the Board replied that it would grant no blanket authority for the opening of branches, that each application must be presented separately and would be considered on its merits, subject to the approval of the state banking authorities and the recommendation of the federal reserve bank of the district. Applications to establish branches in non-contiguous territory, filed before February 1, 1924, would be considered by the Board after that date and each case would be decided on its merits. It was evident however that further definition and clarification was necessary to cover cases that might arise in the future. Therefore the Board drafted a set of formal regulations which were finally issued in amended form April 7, 1924

Branch Banking Regulations of 1924

These regulations reiterated in general the resolutions of November 7, 1923, with the following changes:

1. Branches would be restricted to the home city or contiguous territory except where the state banking authorities certified, and the Board found, that public necessity and advantage render a departure from this principle necessary or desirable.
2. As a general rule, it would not consider applications for permits to establish branches unless state author-

ities "regularly made simultaneous examination of the head office and all branches." These examinations must give the Board sufficient information as to the condition and management of the bank in order to protect the interests of the public.

3. The Board would require each bank establishing or maintaining a branch to maintain for itself and branches "an adequate ratio of capital to total liabilities and an adequate percentage of its total investments in the form of paper or securities eligible for rediscount or purchase by Federal reserve banks."
4. The Board would not consider any application to establish a branch, agency, or additional office until the state banking authorities had approved its establishment. Furthermore, the directors and the federal reserve agent of the reserve bank in that district must report upon the condition and management of the bank, the effect of the opening of such branch upon other banks or branches in that locality, and whether it would be in the interest of the public in that community to establish such a branch or office. In addition, the federal reserve bank must make a recommendation as to whether the permit should be granted.
5. A permit would become void in six months if the branch was not established before that time.
6. —The Board reserved the right to cancel any permit if it was shown, after a hearing that the branch, agency, or additional office was being operated in a manner contrary to the interests of the public in that locality.

Complaints of Member State Banks

This rather drastic modification of federal reserve branch banking policy was not accomplished without strong protests from the member state banks which were operating branch banking systems. These banks claimed that they were not being treated fairly, that they had been told that

upon joining the system they would be permitted to retain the charter and statutory privileges given them under state law. The law also said they might continue to exercise all corporate powers granted by the state in which they were created. The right to engage in branch banking was one of these rights. Therefore the Federal Reserve Board was modifying the conditions upon which these banks had entered the system.

Two rulings of the Federal Reserve Board were cited as further authority by the branch bankers. June 12, 1915, the Board in an informal ruling said that trust companies having branches were eligible for membership and might continue to maintain such branches. On July 29 of the same year the Board anounced that it did not intend to deny to an institution having branches the right to add additional branches after joining the system, except for reasons that might influence a state banking department in also disapproving such branches.

The California members were especially critical. They claimed that they had been asked to join, many of them had done so during the war as a patriotic duty, and that they had been assured by the Federal Reserve Bank of San Francisco and the Federal Reserve Board that their branch banking privileges would remain intact. Now, they alleged, the Federal Reserve Board had not lived up to its promise.[15] The Federal Reserve Board countered with the argument that while the law did state that banks might retain their state charter and statutory privileges and all corporate powers granted, yet the same section of the law also specifically stated that such privileges should be exercised in accordance with the provisions of the Federal Reserve Act and the regulations of the Board made pursuant thereto. Therefore the Board was well within its rights

[15] This argument is fully treated in C. W. Collins, *The Branch Banking Question,* Chapter X. Also see *Senate Hearings on The McFadden Bill,* H. R. 8887, 68th Session, 2nd Session, part 2., pp. 66, 72, 74, 79, 83, 110, and 119. Also see *House hearings on same bill*, pp. 64–139.

in placing restrictions upon branch banking. Furthermore, member state banks could not expect that the conditions upon which they entered the system and operated under it would not be changed at some future time.

While the Federal Reserve Board was clearly within its rights under the Federal Reserve Act, the member state banks could not be blamed for feeling that they had been mistreated.

Additional Offices for National Banks

Reference has been made previously to the fact that in the effort to remedy the inequalities under which the national banks were operating with regard to the establishment of branches Comptroller of the Currency Crissinger in 1922 began to permit national banks to open additional offices or agencies in their home cities, where state banking institutions enjoyed such privileges under state law. Before 1922 no national bank had been permitted to establish new branches, additional offices or agencies. Such branches as they possessed had been acquired by absorbing state banks with already existing branches, by conversion of a state bank with branches into a national bank, or by consolidation with a national bank which had previously acquired branches in one of the two aforementioned ways. The additional offices approved by Comptroller Crissinger were not to engage in a general banking business. This was not permissible. Such offices were thought to be legal when they limited their functions to the receipt of deposits and the cashing of checks. Such branches are sometimes called "additional teller's windows".[16] Previous to this time the various comptrollers of the currency had guided their actions in this respect by the opinion of Attorney-General Wickersham, rendered May 11, 1911.[17] Comptroller Cris-

[16] A copy of the letter in which the Comptroller stated this policy is found in Willis and Steiner, *Federal Reserve Banking Practice,* pp. 739–741.

[17] See *Opinions of Attorney-General,* Vol. 29, p. 81.

singer's policy was not in contradiction to the decision of the Attorney-General, for Wickersham had simply stated that national banks did not have the right to establish a branch wherein a general banking business might be conducted. The action, however, was not in accord with a decision of the Solicitor of the Treasury Department, July 25, 1910, to the effect that National banks could not open branches or agencies for the purpose of receiving deposits or cashing checks.. The offices approved by Comptroller Crissinger did not engage in general banking, but at the same time there was no specific authority for granting them in the National Bank Act. From June 3, 1922, to April 30, 1923, the Comptroller approved ninety-seven permits for additional offices. He then became Governor of the Federal Reserve Board and was succeeded by Mr. Henry M. Dawes.

In order to ascertain whether the opening of additional offices by national banks was legal Comptroller Dawes requested an opinion on this question from the Attorney-General of the United States. Attorney-General Daugherty replied on October 3, 1923, that national banks could open offices for the "performance of such routine services as the receipt of deposits and the cashing of checks for their customers." Such offices however must be limited to the home city of the parent bank.[18] Comptroller Dawes then drew up regulations under which national banks might open such additional offices. One of the conditions was that no such office could be opened unless state bank competitors were permitted by state law to engage in branch banking.[19] Up to the beginning of 1927 nearly 300 permits to open additional offices had been granted.

With the approval of the McFadden Bill, February 25, 1927, the national banks have secured for the first time the right to open branches in their home city for the purpose

[18] *Fed. Res. Bull.*, Oct., 1923, p. 1196.

[19] *Annual Report of the Comptroller of the Currency for 1923*, pp. 151–155.

of conducting a general banking business. The significance of this measure will now be discussed.[20]

THE McFADDEN-PEPPER BANK ACT

It will be recalled that beginning with its 1915 report the Federal Reserve Board constantly urged upon Congress the advisability of broadening the powers of the national banks to establish branches in order to permit them to meet the growing competition of the state banks. The Senate twice passed bills slightly remedying the situation but each time the House refused to give its approval to the measure. It became increasingly evident that the powers of the national banks must be liberalized in other ways as well. The decline in the relative power of the national banks has been treated in Chapter XI of this volume. There it was shown that the national banks were controlling a gradually decreasing proportion of the country's banking resources and deposits. Many national banks were giving up their national charters and reorganizing as state banks. It became imperative to extend the powers of the national banks if the national banking system was to retain its importance. Congressman McFadden described the situation as follows: [21]

> "The multiplication of state banks, their liberal and modern charters, their growing resources now surpassing those of the national banks have made them deadly competitors of the national banks. If the latter are not armed to meet the emergency they will have to give up their national charters and be-

[20] That a national bank has no right to open new branches doing a general banking business in a state which prohibits branch banking was decided in First National Bank of St. Louis v. State of Missouri, 263 U. S. 640–668, (1924). The St. Louis Bank had opened a branch without the approval of the Comptroller of the Currency. The decision stated that inasmuch as there was no specific grant of power to open branches in the National Bank Act that the Missouri law should govern since it was contrary to no federal enactment. For a discussion of this case see, Collins, C. W., *The Branch Banking Question,* The MacMillan Co., N. Y., pp. 59–70. Also see *Fed. Res. Bull.,* April, 1924, pp. 281–285.

[21] Louis T. McFadden, "Is Our Banking System Becoming Defective," *The Magazine of Wall Street,* July 3, 1926, p. 421.

come state banks. The process of dissociation is already in full swing." . . . Then referring to the fact that in the last two years 166 national banks had given up their charters, he continued, "If this tendency continues we may look forward to a time when the federal reserve system will be composed of banks not under federal supervision and at liberty to quit the system at will. A national credit regulating organization under the banking supervision and control of 48 governments would be a monstrosity and a tragic one."

A bill was drafted under the supervision of Comptroller Dawes and introduced in Congress in 1924 by Chairman McFadden of the House Banking and Currency Committee. It straightway became the subject of widespread debate and aroused both commendation and criticism.

Most of the controversy centered around the branch banking provisions of the bill. Congressman Morton D. Hull of Illinois drafted amendments to the bill which immediately became famous as the Hull Amendments. These Amendments provided that national banks and member state banks would never be allowed to have branches in states which did not at the time of the passage of the act specifically permit state banks to have branches. Even if a state which did not permit branch banking should subsequently do so, the national banks and member state banks would be forever barred from opening branches in that state. Even if the nonmember state banks in that state developed branch banking systems all member banks would have been forever barred from doing so unless Congress modified the law. The unfairness of the Hull Amendments to the national and member state banks is clearly evident. In spite of this they received the approval of the American Banker's Association at its 1924 Convention. The amendments drew their support from the opponents of branch banking who felt that their enactment would restrict branch banking to the 22 states now permitting it in some form. If national and state member banks could never engage in branch banking in the other 26 states it was believed that

they would fight any attempt of state legislatures to grant branch banking powers to state banks. Those who opposed the Hull Amendments countered with the argument that instead of restricting branch banking the amendments would encourage it because the state banks in the 26 non-branch banking states knowing that member banks could not have branches would endeavor to secure the privilege for themselves as a means of making national banking still less profitable. It is impossible to describe adequately here the bitterness of the struggle which centered around the Hull Amendments. It all but wrecked the chances of getting any national bank legislation through Congress.

It is inadvisable here to trace the ups and downs of the McFadden Bill in Congress. It did not come to a final vote in either house in the first session of the 68th Congress. In the second session it was passed by the House June 14, 1925, but not acted upon in the Senate.[22] In the first session of the 69th Congress its chances improved. It passed the House with the Hull Amendments, February 4, 1926. The Senate approved it without the Hull Amendments and with other changes May 13, 1926. The conference committees were unable to agree. The Senate Committee refused to accept the Hull Amendments and the House Committee refused to exclude them. The ensuing deadlock could not be broken and the session ended with no action taken. The foregoing account tells little of the struggle which went on, both Houses adopting an uncompromising attitude on the Hull Amendments and refusing to give an inch.

It was evident that the McFadden Bill with the Hull Amendments would never become law. Much of the support of these amendments had come from the American Bankers' Association, in spite of the fact that practically every officer of the federal reserve banks, the Federal Re-

[22] For a detailed account of the McFadden Bill in Congress see Collins, *The Branch Banking Question,* Chapters VIII and IX. Also see the files of the *U. S. Investor* during this period.

serve Board, and the officers of the Treasury Department came out against them. At its Los Angeles Convention in 1926 the American Bankers' Association reversed its position and advocated the passage of the bill without the amendments, by a vote of 413 to 268. The State Bank Division of this Association, however, refused to deviate from its support of the Hull Amendments.[23]

When the second session of the 69th Congress assembled hopes of passing the bill improved. In view of the changed attitude of the American Bankers' Association the House seemed less inclined to support the Hull Amendments. Its conference committee reported that the Senate would never accept the amendments and by a vote of 228 to 166 the House on January 24, 1927, approved the bill without the Hull Amendments, but after a most bitter debate. As the session was to expire on March 4, prompt action by the Senate was necessary. As the weeks went by the Senate became involved in other questions and it looked for a while as if the bill would again fail of passage. Newspaper accounts state that an alliance was formed between the supporters of the McNary-Haugen Bill for agricultural relief and the advocates of the McFadden Bill. However that may be, the Bill was brought to a vote, passed by the Senate in the identical form in which it passed the house, and received the approval of the President, February 25, 1927. Thus ended one of the most spectacular controversies over banking legislation in recent years.

Provisions of the Act

Since the branch banking provisions are for our purpose the most important they will be considered first. The Act amended Section 9 of the Federal Reserve Act by definitely stating that any state bank could join the federal reserve system and retain all branches in existence at the time of the approval of the act (February 25, 1927), pro-

[23] *Com. and Fin. Chronicle Supp.*, Oct. 16, 1926, pp. 93–102.

vided such branches were permitted by state law. But no such bank could join and retain any out-of-town branches established after February 25, 1927. No member state bank can now open any branches beyond the limits of the city, town, or village in which the parent bank is located.[24] New home city branches are still permissible.

National bank branches are provided for as follows:

1. A national bank may maintain and operate all branches which are in lawful operation at the time of the approval of this act. In addition, any national bank which has continuously maintained and operated not more than one branch for a period of 25 years preceding the approval of this act may continue to operate the branch. This last provision apparently was to take care of branches of doubtful legality.
2. If a state bank converts into or consolidates with a national bank, or if two national banks consolidate, the converted or consolidated association may retain and operate all branches of the converting or consolidating banks which were in lawful operation at the date of approval of this act.
3. After the date of the approval of this act any national bank might establish and operate *new* branches within the limits of the city, town, or village in which the bank is located, provided the state law permits state banks to have such branches. This gives the national banks the right to open *new* branches to engage in general banking where the state law permits branch banking. Previous to this amendment national banks had been able to open only additional offices or agencies of limited banking powers under permission of the Comptroller of the Currency. The right to establish such branches was however limited by the next section.

[24] The Federal Reserve Board Ruled in 1927 no state member bank could open a branch in a town whose corporate limits coincided with the corporate limits of the city, town, or village in which the parent bank was located. *Fed. Res. Bull.*, July, 1927, p. 500.

4. Such *new* branches could not be opened in the future in cities or towns of less than 25,000 population. One such branch could be established if the population was over 25,000 and less than 50,000. Two branches were permissible if the population was over 50,000 and less than 100,000. In cities of over 100,000 population the number of branches could be determined by the Comptroller of the Currency.
5. No change in location of branches could be made without the consent of the Comptroller of the Currency.
6. The word "branch" as used in these sections includes any branch bank, branch office, branch agency, additional office, or any branch place of business where deposits are received, checks paid, or money lent.

Modification of Branch Banking Policy

This law requires a modification of the branch banking policy of the Federal Reserve Board in two respects. In its 1924 Regulations the Board stated it would approve new branches for member state banks in territory "contiguous" to the home city of the parent bank.[25] The Senate wished to enact this regulation into law but the House refused to do so, so the Senate yielded on this point. Branches established in the future, therefore, must be limited strictly to the corporate limits of the home city or town of the parent bank.

The Board also stated in the regulations that it might grant permission for member state banks to establish out-of-town branches where the state banking authorities certified and the Board found that public necessity and advantage made out-of-town branches desirable. The Act as passed makes the exercise of such discretionary power impossible, no new out-of-town branches being permitted.

[25] Contiguous territory was defined as meaning other cities or towns, the limits of which coincided at some point with the corporate limits of the home city of the parent bank.

Amendments Favored by the House

The House had desired to compel state banks joining the system to relinquish all out-of-town branches, even if acquired before the approval of the Act. It attempted to make a further restriction of the following nature: If a state which prohibited branch banking should subsequently permit it, no state bank should be permitted to join the system and retain branches established in that state after the approval of the Act. The House further desired to make it impossible for any member state bank ever to establish a branch in any state now prohibiting branch banking. This was an attempt to make the Hull Amendments applicable to member state banks. The House also attempted to restrict the establishment of future branches by member state banks according to the size of the city. No member state bank could have in the future established a branch in a town which in 1920 had less than 25,000 population, could have established one only if the population was between 25,000 and 50,000, and only two where the population was between 50,000 and 100,000. If this bank had this number of branches when the Act was passed it could establish no more. The Senate, however, refused to accept any of these restrictions and they were eliminated.

The House had desired to prevent state banks which converted into national banks from retaining their out-of-town branches. It was willing to let existing national banks retain their branches. But no state bank located in a state which at the time of the passage of this Act forbade branches could convert into a national bank and retain any branches established subsequently in those states should the state later permit branch banking. Had the first of these prohibitions been adopted the recent nationalization of the Bank of Italy in California would probably have been prevented. But fortunately they were not enacted.[26]

[26] For the various provisions of the bill as passed by the House May 14, 1926, and amended by the Senate see the official copy of H. R. 2, 1st session 69th Congress.

Other Provisions

Most of the other sections of the Act affected only the national banks. They were passed in an effort to make national bank charters more desirable. Among the amendments are the following:

1. Probably the most important clause is that giving the national banks the right to lend on improved city real estate for a period of five years. Loans of this character should not be in excess of 50 per cent of the actual value of the land. Total loans made should not exceed 25 per cent of the paid-in and unimpaired capital and surplus or one-half of the savings deposits. This will probably be of great benefit to the national banks in building up their savings departments. Now that savings deposits may be invested more extensively in real estate mortgages, national banks can bid more successfully for time deposits and meet state bank and trust company competition in this respect. Previously such loans could not exceed one-third of the time deposits and could run only for one year, so short a period that national banks could make little use of the privilege (Section 15).
2. National banks are given indeterminate charters, which makes it possible for them to engage more extensively in fiduciary functions and compete more effectively with trust companies. Previously national banks with their 99 year charters could not assume perpetual trusts. (Section 2).
3. Although national banks can still lend to any one borrower an amount equal only to 10 per cent of the bank's capital and surplus, the Act makes still further exceptions on certain types of paper which are not to be included in this maximum. In this way more credit can be extended to one borrower than before. (Section 9).

4. A state bank can now consolidate directly with a national bank without first having to convert into a national bank as formerly. (Section 3).
5. The powers of national banks to engage in investment business are broadened. (Section 2).
6. National banks can engage more satisfactorily in the safe deposit business. (Section 2).
7. These banks can in the future issue stock dividends, a privilege previously denied to them. (Section 5).
8. National banks can now issue stock with less than a hundred dollars par value. (Section 16).
9. In the outlying districts of cities over 50,000 in population, where state laws permit the organization of banks with a capital of $100,000 or less, national banks with the approval of the Comptroller of the Currency can now be organized with a capital of not less than $100,000. Previously, in a city of this size, the capital had to be $200,000. (Section 4).

Indeterminate Charters For Federal Reserve Banks

From the standpoint of the federal reserve system as a whole a most important provision of the Act was that giving the federal reserve banks indeterminate charters. (Section 18). Their charters would have expired automatically in 1933, and it was believed to be of highest importance to put them in a more permanent basis. The inclusion of this section in the Act was due to the insistence of the Senate. It does not mean, however, that the charters are irrevocable, on the contrary Congress may now at any time dissolve the entire federal reserve system. While there may be some danger of this it is very slight. Federal reserve banks will not now be compelled to go out of existence if their charters are not renewed before a specific date, and are thus saved from the fate which met the First and Second Banks of the United States.

Conclusions

Such are the main provisions of the McFadden Bank Act, one of the most important banking measures ever enacted in this country. Its chief importance lies in the fact that it has probably stopped a further decline in the strength of the national banking system. Already signs of what it may bring are in evidence. For example, the Bank of Italy in California has taken out a national charter, and it becomes with its state-wide branch banking system the largest national bank in the country outside of New York City from the point of view of deposits and resources. A number of conversions and consolidations under the Act are in progress. The resources of the national banking system have already been increased $1,000,000,000 by conversions and consolidations since the passage of the Act. Whether many more banks will nationalize in the near future remains to be seen, but at least withdrawals from the national system will probably be lessened. It is highly regrettable that the delay in enacting the law led so many of the oldest and largest national banks in the country to convert into state institutions. It is doubtful whether many of them will now come back into the national system, but the chances of losing many more such banks have been greatly lessened.

The law, however, will probably not induce many more state banks to join the system. It cannot be justly criticised on that score. That was not the question at issue. The problem was to maintain membership in the national banking system which always has been and probably always will be the backbone of the federal reserve system. While a larger membership of state banks is highly desirable, there is probably little that can be done to bring them in so long as they get all of the advantages of the system while remaining outside of it.

The McFadden bill was, in the closing days of Congress, frequently referred to in the press as a branch bank-

ing bill. As a matter of fact, it might as justly be called an anti-branch banking bill, for it definitely restricts to a great degree the further development of branch banking inside of the federal reserve system. While national banks may now open new branches they can have more than two branches in only the comparatively few cities with a population of over 100,000. All future new branches must be in the home city of the parent bank. No member state bank or national bank can establish a branch outside of its home city. Some expansion on the part of national bank branches is possible and this is highly advantageous to them but on the whole restrictions are rather heavy.

We are not here concerned with the relative advantages or disadvantages of branch banking. Probably in the long run branch banking is safer than a system of independent unit banks. The United States is the only one of the large civilized countries without an extensive branch bank system. The Joint Commission of Agricultural Inquiry believed that a limited system of branch banking might furnish a possible solution for the existing situation in this country.[27] The Federal Reserve Board stated in 1922 that branch banking in California had lowered the rate of interest in some of the leading agricultural sections of that state and at the same time had provided added security for the deposits of farmers.[28] Certain officers of the federal reserve system and members of the Federal Reserve Board believe that it was a mistake to restrict the further development of state-wide branch banking within the federal reserve system. Vice-Governor Platt of the Federal Reserve Board was one of those who believed that there were many nonmembers with out-of-town branches whose membership was desirable. In June, 1924, there were, he

[27] *Report of the Joint Commission of Agricultural Inquiry*, Part II on Credit, Chapter VIII, 1922.

[28] 9 Fed. Res. Board, 1922, pp. 5–6.

said, 245 such nonmembers in 23 states.[29] Largely as a result of the arguments advanced by Platt and others holding his views, of which there were many, the bill as finally enacted permitted state banks to enter the system and retain all out-of-town branches established prior to February 25, 1927. While the limitations on branch banking contained in the Act may be deplored by many, yet there is cause for satisfaction in the fact that the Act finally granted branch banking privileges to the extent that it did. In view of the prevalence of anti-branch banking sentiment in the country at present it must be regarded as quite an achievement.[30]

[29] See arguments advanced by Mr. Platt in *Journal American Bankers Association,* December, 1925, p. 404; also *Com. and Fin. Chronicle,* July 10, 1926, pp. 159–160.

[30] No mention is made in this chapter of the rather extensive development of "chain" banks, groups of banks owned by the same individuals or by a holding company. Chain banks exist in some states which prohibit branch banking. One such system controlled 175 small banks. (9 Fed. Res. Board, 1922, p. 6). Willis and Steiner say that in 1920 probably 500 national banks were affiliated with such systems. (p. 734).

For an excellent study of the provisions of the McFadden Act see article by Howard H. Preston in the *American Economic Review* for June, 1927.

CHAPTER XVI

CONCLUSION

THE relationship between the state banking institutions and the federal reserve system has now been discussed at some length. Although, at first, there was some doubt as to whether state banks and trust companies should be permitted to enter the system, it is now generally believed that their membership has been an important factor in the success so far attained by the federal reserve banks.

The reasons why only 53 state banks and trust companies had joined by the middle of 1917 have been outlined. The amendments of June 21, 1917 did much to remove the objections of the state bankers with the result that over 1,650 state banks and trust companies were listed as members during the latter part of 1922. How many of the new members joined in response to the appeal made by President Wilson to their patriotism during the war cannot be determined. To many, however, the main reason for membership was a desire to place themselves in a position of safety during the war and the ensuing period of speculation.

Seventeen thousand state banks and trust companies still remain outside of the system. Only one-half of these were eligible before March 4, 1923. But even after the Agricultural Credits Act of that date over 6,000 banks and trust companies could not join, even should they so desire, because of too small a capital. After a review of the reasons why the eligible banks still refuse to enroll and the number of members gradually declines it has been decided that there is little hope of increasing state bank and trust company membership. Membership is not profitable finan-

cially in many cases as the nonmembers generally secure access to the resources of the federal reserve system through their large city correspondents which are members. This situation joined with the fact that no interest is paid on the reserve deposited in the federal reserve banks and that members can not count "float" as reserve offers a sufficient excuse for nonmembership to many bankers. It may be that a plan for distributing an increased share in the profits of the reserve banks to the members might induce some reluctant banks to enter. But there are many dangers involved in such a drastic change in policy.

If a larger proportion of reserve bank earnings could be distributed to the members without committing the federal reserve system to a profit making policy it might not be objectionable to do so. But earnings have been so small during the past few years that it is doubtful whether the amount distributed would be large enough to encourage any increased membership.

The number of state bank and trust company members was, on June 30, 1928, 400 less than in 1922. The two chief reasons for this decline in membership have been bank failures and voluntary withdrawals from the system. Other causes are consolidation, mergers, and conversion into national banks. A small further decline in state bank membership may be expected. In spite of this the state bank and trust company members were until 1927 controlling a gradually increasing proportion of the total resources of the federal reserve system. While their importance was increasing that of the national banks was relatively declining. The McFadden-Pepper Bank Act of 1927 seems to have stopped, at least temporarily, the relative decline of the national banks. The fact that there are two types of members in the system has caused its administrators no end of trouble. The utmost caution has been required at times to prevent the state bank and trust company members from securing too many advantages which are denied to the

national banks. Nevertheless the non-national members have been and still are able to exercise functions denied to national banks. Before the passage of the McFadden-Pepper Act of February 25, 1927, member state banking institutions were favored over the national banks in the following respects:

1. They might withdraw from the system at will, after six months' notice. Two hundred of them have done so. National banks could not withdraw without surrendering their charters. (Not changed by the McFadden-Pepper Act.)

2. State bank and trust company members, upon joining, might and still do retain the statutory and charter privileges given them under state laws, provided the Federal Reserve Act and the regulations of the board are not violated thereby. In this way they engage in certain types of business and enjoy privileges denied to the national banks. A specific example of the benefits derived from this clause might be found in the branch banking activities of member state banks. (The McFadden-Pepper Act modified the powers of the state member banks to engage in branch banking. In addition, it was the interpretation of this clause by the acting Attorney-General in 1917 that exempted the member state institutions from the prohibitions of the Clayton Act against the interlocking of bank directorates. National banks were, however, and still are, subject to the Clayton Act.

3. National banks might not lend to any one borrower an amount in excess of 10 per cent of the lending bank's capital and surplus. There were, however, certain types of obligations which did not come under this limitation. State bank members, on the other hand, might lend an amount greater than 10 per cent of their capital and surplus to one borrower; but if they did so they could not rediscount any of that borrower's paper at the federal reserve bank. They could, however, by rediscounting the excess over 10 per cent with another bank, rediscount the rest of this borrower's paper at the federal reserve bank.

(The change effected by the McFadden-Pepper Act was to increase the amount and type of obligations not coming under the limitation before mentioned, not being classed as loans).

4. State bank members were not subject to the regulations issued by the Comptroller of the Currency, neither were they required to report to him. National banks had to report, not only to the federal reserve banks, but also to the comptroller and obey his regulations. (Not changed by the McFadden-Pepper Act).

5. Examinations of state bank members by their own state examiners were, and still are, frequently accepted by the federal reserve bank as being sufficient. National banks feel that this subjects state members to less rigorous control.

6. Trust company members in some states had been given perpetual charters and so could accept permanent trusts. National banks possessing fiduciary powers could not accept permanent trusts, as their charters ran only for a limited period. (The McFadden-Pepper Act removed this inequality by giving the national banks indeterminate charters).

7. State bank members were greatly favored in making loans on real estate and farm lands. No definite limit was set upon the amount or maturity of such loans, either by the Federal Reserve Act or the Federal Reserve Board. But national banks were definitely restricted as to the amount and maturity of such loans. They could not lend on such security an amount greater than 25 per cent of their paid-in and unimpaired capital and surplus, or one-third of their time deposits. The greatest handicap lay in the restriction that national banks could not make loans on improved city real estate with a maturity of more than one year. But all that was required of state bank members was that they should not lend on real estate and farm land to an amount which would seriously impair their liquidity.

(The McFadden-Pepper Act removed some of the handicaps from which the national banks suffered in this respect. The Act, however, left state bank members as free from restrictions as before).

8. State bank members in states whose laws were favorable enjoyed more extensive branch banking privileges than did the national banks. National banks have never been permitted to engage in state-wide branch banking, except as out-of-town branches were acquired by absorbing a state bank with such branches. Before 1927 only twelve national banks in the entire country had out-of-town branches, and the total number of such branches came to only twenty-five. But a number of state bank members engaged in extensive state-wide branch banking, as, for example, in California. (The McFadden-Pepper Act has placed all member banks upon a position of equality for the future as regards branch banking.)

Consequently the advantages of a national bank charter have during recent years been growing less and less. Because of more lenient restrictions on real estate and other loans, examinations, trust, safe deposit, and investment business as well as branch banking the national banking system has been declining in relative importance during the past few years. The approval of the McFadden National Bank Bill on February 25, 1927 is an attempt to prevent further inroads upon the national banking system. Whether it will be successful in preventing the drift away from national charters remains to be seen, but it at least removes some of the most glaring inequalities previously existing between these two types of members. National banks may now engage more extensively in loans on city real estate, may now go more extensively into safe deposit and investment business, and are given branch banking privileges which were hitherto denied them. How effective this measure will be only the future can reveal, but at the present time it looks as if it will to a large degree accomplish its purpose.

It has been extremely difficult to make membership more attractive for state banks and trust companies without at the same time making it less so for national banks. Some authorities feel that the amendments of June 21, 1917, which gave the non-national members many special privileges was the worst thing that could have happened to the national banking system. They maintain that attention should have been centered on making a national charter more desirable and not less so. Every privilege granted non-national members weakens by just so much the prospect of increasing the power of the national banking system.

The maintenance of high banking standards in the country to-day depends upon the perpetuation of the national banking system. National banks are and must remain the backbone of the federal reserve system. It is true that in some states the non-national banks are required to conduct themselves according to the highest dictates of banking practice. Some national banks are weaker than many non-national institutions. The failure of 700 national banks since 1920 bears all too distressing testimony on that point. But taking the country as a whole national banks have come through the last few years of banking chaos in better shape than their state competitors.

The question is frequently asked whether the membership of a much larger number of state banks and trust companies is essential to the accomplishment of the main purposes of the federal reserve system. There are those who say that such an increase is not desirable because the system may become too unwieldy, or suffer from a decline in the quality of membership, that it is better to restrict membership to a small number of carefully selected state institutions in sound condition. Many of those holding such views favor releasing all national banks of the smaller type from compulsory membership. These authorities claim that membership should be restricted to those banks which make constant use of the federal reserve banks for

borrowing or rediscounting purposes, that banks which need assistance only occasionally should remain outside and get help through members. Opposed to this view is a widely held opinion that ideal functioning of the system can be attained only by inducing every eligible bank in sound condition to enter.

Both of these views seem to be rather extreme. It is difficult to believe that among the 8,500 banks which are still eligible under the original requirements there are not several thousand whose membership is desirable in order to secure a greater uniformity of control. The success of the federal reserve system does not depend upon having all the banks in the country in it, but it is hard to see how such defects of the old system as decentralization of control and lack of power to mobilize reserves can be completely eradicated while so many banks remain outside of the system. The unification of our banking system is impossible so long as this situation exists. Nonmembers may obtain aid indirectly through their correspondents which are members, but so long as they remain outside they do not have direct access to the main reservoir of credit in case of emergency, and they might find some time that dependence upon correspondents was disasterous. Comparative figures of failures among members and nonmembers reveal that in this group of nonmember banking institutions lies the weakest spot in our banking system today.

On the other hand, it is fairly clear that it would not be advisable to include all eligible banks in the federal reserve system. Banks which do primarily a commercial business upon sound principles should probably be enrolled. For banks doing primarily an investment or fiduciary business, membership is not believed to be necessary or desirable, unless such banks for the purposes of their own safety wish to carry among their investments a supply of self-liquidating commercial paper eligible for rediscount at the federal reserve bank. Mutual savings banks are not

eligible, since they have no capital stock. Many students, however, believe that it would be beneficial to permit mutual savings banks to become associate members upon subscribing a certain percentage of their surplus, and encouraging them, changing the state law where necessary, to carry a supply of short-time commercial paper of the eligible variety. Private banks are not eligible.

With regard to the small country banks dealing largely with farmers and stockmen considerable doubt arises. Where these banks do a considerable commercial business or deal in short-time agricultural or live stock paper, it may be desirable to include them, although there is difference of opinion on this point. If they engage primarily in granting long-time agricultural credits, but at the same time carry among their investments a fair proportion of short-time paper of the eligible kind it may still be desirable mainly for their own safety to include them in the federal reserve system. Where, however, these banks deal almost entirely in agricultural or live stock paper of distant maturity it is difficult to see how membership can be beneficial to them or improve the functioning of the federal reserve system. The federal reserve system is primarily a commercial banking system and in such a system liquidity of assets is essential.

Nevertheless certain organizations have urged the small country bank to apply for membership. Mr. Gray Silver of the American Farm Bureau Federation, Mr. Eugene Meyer, Jr., formerly Managing Director of the War Finance Corporation, and the Joint Commission of Agricultural Inquiry all believed that one of the chief reasons for agricultural distress during 1920 and 1921 was that farmers were in general denied access to the resources of the federal reserve system because so few country banks were members. They all asserted that a larger country bank membership was highly desirable as a means of assisting the farmer. In reply to them it has been argued that the

type of credit furnished by the federal reserve banks is of little value to farmers.[1]

The opinion of the Federal Reserve Board on this question is shown by the following statement:[2]

"Larger membership in the reserve system would undoubtedly increase its usefulness by enabling it to reach more directly a greater number of banks, particularly in the rural communities. Since the addition to membership of the smaller rural banks, however, would add little to the reserves of the system, while it would increase its responsibilities, the desirability of their admission rests not upon their contribution to the strength of the system but upon the fact that through their admission the benefits of the reserve system would be more widely distributed. The strength and effectiveness of the federal reserve banks is not dependent upon increased membership, and the desirability of further growth arises from the advantages of membership to the banks that join and to the communities which they serve."

Governor Crissinger of the Federal Reserve Board and Paul M. Warburg, a former member of the Board, in their testimony before the joint committee of Inquiry into Federal Reserve Membership, stated that while the system would gain much from more members the bars must not be let down further to bring more in. More members would, they said, help the banks as a whole and their communities and result in better examinations, but to pay interest on reserve deposits would be too high a price to pay for increased membership. Governor Crissinger thought the nonmembership of so many banks made the farmer pay more for the money he borrowed.[3]

Granting then that a larger membership of state banks and trust companies is desirable, should the Federal Reserve Act be amended to make membership more attractive. With the possible exception of a provision for a somewhat wider distribution of the earnings of the federal

[1] See Chapter XI this Volume, Section on Agricultural Credits Act of 1923.

[2] *Fed. Res. Bull.*, November, 1923, pp. 1178–9.

[3] *U. S. Investor*, October 20, 1923, p. 131. (Vol. 34, p. 2483).

reserve banks, such as that sponsored by the New England bankers in 1923, the writer believes little can be done in this respect. While only approximately one-third of all the banks in the country belong to the system the federal reserve banks now control two-thirds of all the banking resources in the entire country, and over three-fourths of all the commercial banking resources. Although not rapidly increasing its control over the banking power of the country, the system is surely holding its own. It is in no danger of disintegrating. The McFadden National Bank Act of February 25, 1927 has made the charters of the reserve banks indeterminate. This is a most important achievement. It seems now hardly likely that the federal reserve system should suffer at some future date the fate of the First and Second Banks of the United States. That being true its standards of banking practice must not be lowered further.

A proposed amendment which has received rather wide support would decrease the amount of the reserve requirement for country banks. Those holding this view argue that the country banker needs to keep proportionately more actual cash in his vault than do city banks. It is added, furthermore, that since the "float" must now be carried by the bank itself, the actual reduction in country bank reserves accomplished by the federal reserve system is not so great as many believe. It was arguments such as these that led Congressman Louis T. McFadden to introduce a bill, H.R. 12453, permitting country banks to keep 40 per cent of the required 7 per cent reserve against demand deposits in their own vault or with a correspondent. Because of the confusion which ensued, many persons not distinguishing this bill from the McFadden National Bank Bill, this bill was withdrawn.[4] While, it might be an open

[4] Louis T. McFadden, "Relief for the Country Banker," *Journal A. B. A.*, May, 1925, pp. 665–6.

question, the writer doubts the wisdom of passing an amendment of this nature.

Whether members can be prevented by law from extending indirectly the benefits of the federal reserve system to their nonmember correspondents is a question deserving the closest study. The writer does not see how this can be accomplished except by convincing the members of the undesirability of this practice. But just so long as nonmembers share so widely in the benefits of the system from the outside, just so long is any further increase in state bank and trust company membership improbable.

In the administration of the system there is probably room for improvement. Here, undoubtedly, is an opportunity for increasing the goodwill of both members and nonmembers. The officers of the federal reserve system have made mistakes, no doubt, such as the institution of forceful methods to drive nonmembers on the par list. But, on the whole, the officers of the system deserve commendation for having met situations involving no end of difficulties with good judgment and skill. It has been said that "The principal weakness of the federal reserve system is the lack luster loyalty of its members." [5] If attention is now centered on improving the administration of the system, meeting

[5] This statement was made by F. P. Bennett in the *United States Investor,* Sept. 8, 1923, p. 33, (Vol. 34, p. 2065). Mr. Bennett admits that members are loyal, but not militantly so. Their support is passive, not active. While the advantages of membership are intangible, all the disadvantages are most tangible and keenly felt.

Mr. Bennett proposes for members an increased share in the profits of the reserve banks, not a definite percentage however. *U. S. Investor,* Sept. 1, 1923, p. 9, Vol. 34, p. 2033). He further advocates a law stating that members will receive the surplus of the reserve banks in case of the abolition of the system. But his argument supporting this is that it would prevent congress abolishing the system to secure the surplus for governmental revenues. This argument is hardly convincing, however.

There is more of soundness in his advocacy of annual meetings of the stockholders of the federal reserve banks. There is a large element of truth in his assertion that such meetings would have prevented some of the criticism which has been directed against the federal reserve banks. "We have a system," he says, "whose stockholders are given no incentive to work for the welfare of the system."

delicate situations with tact and diplomacy, encouraging members to feel that it is their system by occasional district meetings of officers of member banks, it may be possible as time goes on to enroll many new members, thereby bringing about a still greater unification of our banking system.

APPENDIX

REGULATION H, SERIES OF 1928

(Superseding Regulation H of 1924)

MEMBERSHIP OF STATE BANKS AND TRUST COMPANIES

SECTION I. BANKS ELIGIBLE FOR MEMBERSHIP

1. *Incorporation.*—In order to be eligible for membership in a Federal reserve bank, a State bank or trust company must have been incorporated under a special or general law of the State or district in which it is located.

2. *Capital stock.*—Under the terms of section 9 of the Federal reserve act as amended, no applying bank can be admitted to membership in a Federal reserve bank unless—

(*a*) It possesses a paid-up, unimpaired capital sufficient to entitle it to become a national banking association in the place where it is situated, under the provisions of the national bank act; or

(*b*) It possesses a paid-up, unimpaired capital of at least 60 per cent of such amount, and, under penalty of loss of membership, complies with the rules and regulations herein prescribed by the Federal Reserve Board fixing the time within which and the method by which the unimpaired capital of such bank shall be increased out of net income to equal the capital required under (*a*).

In order to become a member of the Federal reserve system, therefore, any State bank or trust company must have a minimum paid-up capital stock at the time it becomes a member, as follows:

If located in a city or town with a population—	Minimum capital if admitted under clause (*a*)	Minimum capital if admitted under clause (*b*)
Not exceeding 3,000 inhabitants	$25,000	$15,000
Exceeding 3,000 but not exceeding 6,000 inhabitants	50,000	30,000
Exceeding 6,000 but not exceeding 50,000 inhabitants	100,000	60,000
Exceeding 50,000 inhabitants (except as stated below)	200,000	120,000
In an outlying district [1] of a city with a population exceeding 50,000 inhabitants; provided State law permits organization of State banks in such location with a capital of $100,000 or less	100,000	60,000

[1] The term "outlying district" is construed to mean that portion of a city which is located outside of and at a considerable distance from, the recognized business and financial center of such city, and includes all suburban districts within the corporate limits of such city.

Any bank admitted to membership under clause (*b*) must also, as a condition of membership—the violation of which will subject it to ex-

pulsion from the Federal reserve system—increase its paid-up and unimpaired capital within five years after the approval of its application by the Federal Reserve Board to the amount required under (*a*). For the purpose of providing for such increase, every such bank shall set aside each year in a fund exclusively applicable to such capital increase not less than 50 per cent of its net earnings for the preceding year prior to the payment of dividends, and if such net earnings exceed 12 per cent of the paid-up capital of such bank, then all net earnings in excess of 6 per cent of the paid-up capital shall be carried to such fund, until such fund is large enough to provide for the necessary increase in capital. Whenever such funds shall be large enough to provide for the necessary increase in capital, or at such other time as the Federal Reserve Board may require, such fund or as much thereof as may be necessary shall be converted into capital by a stock dividend or used in any other manner permitted by State law to increase the capital of such bank to the amount required under (*a*): *Provided, however,* That such bank may be excused in whole or in part from compliance with the terms of this paragraph if it increases its capital through the sale of additional stock: *Provided further,* That nothing herein contained shall be construed as requiring any such bank to violate any provision of State law, and in any case in which the requirements of this paragraph are inconsistent with the requirements of State law the requirements of this paragraph may be waived and the subject covered by a special condition of membership to be prescribed by the Federal Reserve Board.

3. *Branches.*—In order to be eligible for membership in a Federal reserve bank, a State bank or trust company must relinquish any branch or branches established by it after February 25, 1927, beyond the corporate limits of the city, town, or village in which the parent bank is situated.

SECTION II. APPLICATION FOR MEMBERSHIP

Any eligible State bank or trust company may make application on F. R. B. Form 83a, made a part of this regulation, to the Federal Reserve Board for an amount of capital stock in the Federal reserve bank of its district equal to 6 per cent of the paid-up capital stock and surplus of such State bank or trust company. This application must be forwarded direct to the Federal reserve agent of the district in which the applying bank or trust company is located and must be accompanied by Exhibits I, II, and III, referred to on page 1 of the application blank.

SECTION III. APPROVAL OF APPLICATION

In passing upon an application the Federal Reserve Board will consider especially—

(1) The financial condition of the applying bank or trust company and the general character of its management;

(2) Whether the corporate powers exercised by the applying bank or trust company are consistent with the purposes of the Federal reserve act; and

(3) Whether the laws of the State or district in which the applying bank or trust company is located contain provisions likely to prevent proper compliance with the provisions of the

Federal reserve act and the regulations of the Federal Reserve Board made in conformity therewith.

If, in the judgment of the Federal Reserve Board, an applying bank or trust company conforms to all the requirements of the Federal reserve act and these regulations, and is otherwise qualified for membership, the board will approve the application subject to such conditions as it may prescribe pursuant to the provisions of the Federal reserve act. When the conditions imposed by the board have been accepted by the applying bank or trust company and the applying bank or trust company has made a payment to the Federal reserve bank of its district of one-half of the amount of its subscription, i. e., 3 per cent of the amount of its paid-up capital and surplus, the appropriate certificate of stock will be issued by the Federal reserve bank and a certificate of membership will be issued by the Federal Reserve Board. The remaining half of its subscription shall be subject to call when deemed necessary by the Federal Reserve Board.

SECTION IV. CONDITIONS OF MEMBERSHIP

Pursuant to the authority contained in the first paragraph of section 9 of the Federal reserve act, which provides that the Federal Reserve Board may permit applying banks to become members of the Federal reserve system "subject to the provisions of this act and to such conditions as it may prescribe pursuant thereto," the Federal Reserve Board will prescribe the following conditions of membership for each bank or trust company hereafter applying for admission to the Federal reserve system, in addition to such other conditions as the board may consider necessary or advisable in the particular case—

(1) Except with the permission of the Federal Reserve Board, such bank or trust company shall not cause or permit any change to be made in the general character of its business or in the scope of the corporate powers exercised by it at the time of admission to membership.

(2) Such bank or trust company shall at all times conduct its business and exercise its powers with due regard to the safety of its depositors.

(3) Except after applying for and receiving the permission of the Federal Reserve Board, such bank or trust company shall not acquire an interest in any other bank or trust company, through the purchase of stock in such other bank or trust company.

(4) Such bank or trust company shall maintain its loans within the limits prescribed by the laws of the State in which it is located.

(5) Such bank or trust company shall reduce to an amount equal to 10 per cent of its capital and surplus all balances in excess thereof, if any, which are carried with banks or trust companies which are not members of the Federal reserve system, and shall at all times maintain such balances within such limits.

(6) Such bank or trust company may accept drafts and bills of exchange drawn upon it of any character permitted by the laws of the State of its incorporation; but the aggregate amount of all acceptances outstanding at any one time shall not exceed the limitations imposed by section 13 of the Federal reserve act, that is, the aggregate amount of acceptances outstanding at any one time which are drawn for the purpose of furnishing dollar exchange in countries specified by the Federal Reserve Board shall not exceed 50 per cent of its capital and surplus,

and the aggregate amount of all other acceptances, whether domestic or foreign, outstanding at any one time shall not exceed 50 per cent of its capital and surplus, except that the Federal Reserve Board, upon the application of such bank or trust company, may increase this limit from 50 per cent to 100 per cent of its capital and surplus: *Provided, however,* That in no event shall the aggregate amount of domestic acceptances outstanding at any one time exceed 50 per cent of the capital and surplus of such bank or trust company.

(7) The board of directors of said bank or trust company shall adopt a resolution authorizing the interchange of reports and information between the Federal reserve bank of the district in which such bank or trust company is located and the banking authorities of the State in which such bank is located.

SECTION V. ESTABLISHMENT OR MAINTENANCE OF BRANCHES

Every State bank which is, or hereafter becomes, a member of the Federal reserve system will be required to comply strictly with the following provision of section 9 of the Federal reserve act as amended by the act of February 25, 1927:

> Any such State bank which, at the date of the approval of this act, has established and is operating a branch or branches in conformity with the State law, may retain and operate the same while remaining or upon becoming a stockholder of such Federal reserve bank; but no such State bank may retain or acquire stock in a Federal reserve bank except upon relinquishment of any branch or branches established after the date of the approval of this act beyond the limits of the city, town, or village in which the parent bank is situated.

This has been interpreted to mean that—

1. Any State member bank which, on February 25, 1927, had established and was actually operating a branch or branches in conformity with the State law is permitted to retain and operate the same while remaining a member of the Federal reserve system, regardless of the location of such branch or branches.
2. Any nonmember State bank which, on February 25, 1927, had established and was actually operating a branch or branches in conformity with State law may, if otherwise eligible, become a member of the Federal reserve system and retain and operate such branches, regardless of their location.
3. In order to remain a member of the Federal reserve system, every State member bank must relinquish any branch or branches established after February 25, 1927, beyond the corporate limits of the city, town, or village in which the parent bank is situated.
4. Any State member bank which establishes any branch or branches after February 25, 1927, beyond the corporate limits of the city, town, or village in which the parent bank is situated must either (*a*) relinquish such branch or branches or (*b*) forfeit all rights and privileges of membership and surrender its stock in the Federal reserve bank.
5. No State bank which has established any branches subsequent to February 25, 1927, beyond the corporate limits of the city, town, or village in which the parent bank is situated may become a member of the Federal reserve system except upon relinquishment of every such branch.
6. State member banks may establish branches within the corporate limits of the city, town, or village in which the parent

bank is situated without obtaining permission of the Federal Reserve Board.

SECTION VI. POWERS AND RESTRICTIONS

Every State bank or trust company while a member of the Federal reserve system—

(1) Shall retain its full charter and statutory rights as a State bank or trust company, subject to the provisions of the Federal reserve act, to the regulations of the Federal Reserve Board, and to the conditions prescribed by the Federal Reserve Board and agreed to by such State bank or trust company prior to its admission;

(2) Shall enjoy all the privileges and observe all those requirements of the Federal reserve act and of the regulations of the Federal Reserve Board made in conformity therewith which are applicable to State banks and trust companies which have become member banks; and

(3) Shall comply at all times with any and all conditions of membership prescribed by the Federal Reserve Board at the time of the admission of such member bank to the Federal reserve system.

SECTION VII. EXAMINATIONS AND REPORTS

Every State bank or trust company, while a member of the Federal reserve system, shall be subject to examinations made by direction of the Federal Reserve Board or of the Federal reserve bank by examiners selected or approved by the Federal Reserve Board.

In order to avoid duplication, examinations of State banks and trust companies made by State authorities will be accepted in lieu of examinations by examiners selected or approved by the board wherever these are satisfactory to the directors of the Federal reserve bank, and examiners from the staff of the board or of the Federal reserve banks will, whenever desirable, be designated by the board to act with the examination staff of the State in order that uniformity in the standard of examination may be assured.

Every State bank or trust company, while a member of the Federal reserve system, shall be required to make in each year not less than three reports of condition on F. R. B. Form 105. Such reports shall be made to the Federal reserve bank of its district on call of such bank, on dates to be fixed by the Federal Reserve Board. They shall also make semiannual reports of earnings and dividends on F. R. B. Form 107. F. R. B. Forms 105 and 107 are made a part of this regulation.

REGULATION J, SERIES OF 1928

(Superseding Regulation J of 1924)

CHECK CLEARING AND COLLECTION

SECTION I. STATUTORY PROVISIONS

Section 16 of the Federal reserve act authorizes the Federal Reserve Board to require each Federal reserve bank to exercise the function of a clearing house for its member banks, and section 13 of the Federal

reserve act, as amended by the act approved June 21, 1917, authorizes each Federal reserve bank to receive from any nonmember bank or trust company, solely for the purposes of exchange or of collection, deposits of current funds in lawful money, national-bank notes, Federal reserve notes, checks and drafts payable upon presentation, or maturing notes and bills, provided such nonmember bank or trust company maintains with its Federal reserve bank a balance sufficient to offset the items in transit held for its account by the Federal reserve bank.

SECTION II. GENERAL REQUIREMENTS

In pursuance of the authority vested in it under these provisions of law, the Federal Reserve Board, desiring to afford both to the public and to the various banks of the country a direct, expeditious, and economical system of check collection and settlement of balances, has arranged to have each Federal reserve bank exercise the functions of a clearing house and collect checks for such of its member banks as desire to avail themselves of its privileges and for such nonmember State banks and trust companies as may maintain with the Federal reserve bank balances sufficient to qualify them under the provisions of section 13 to send items to Federal reserve banks for purposes of exchange or of collection. Such nonmember State banks and trust companies will hereinafter be referred to as nonmember clearing banks.

Each Federal reserve bank shall exercise the functions of a clearing house and collect checks under the general terms and conditions hereinafter set forth, and each member bank and nonmember clearing banks shall cooperate fully in the system of check clearance and collection for which provision is herein made.

SECTION III. CHECKS RECEIVED FOR COLLECTION

(1) Each Federal reserve bank will receive at par from its member banks and from nonmember clearing banks in its district, checks[2] drawn on all member and nonmember clearing banks, and checks drawn on all other nonmember banks which are collectible at par in funds acceptable to the Federal reserve bank of the district in which such nonmember banks are located.

(2) Each Federal reserve bank will receive at par from other Federal reserve banks, and from all member and nonmember clearing banks in other Federal reserve districts which are authorized to route direct for the credit of their respective Federal reserve banks, checks drawn on all member and nonmember clearing banks of its district, and checks drawn on all other nonmember banks of its district which are collectible at par in funds acceptable to the collecting Federal reserve bank.

(3) No Federal reserve bank shall receive on deposit or for collection any check drawn on any nonmember bank which can not be collected at par in funds acceptable to the Federal reserve bank of the district in which such nonmember bank is located.

[2] A check is generally defined as a draft or order upon a bank or banking house, purporting to be drawn upon a deposit of funds, for the payment at all events of a certain sum of money to the order of a certain person therein named, or to him or his order, or to bearer, and payable on demand.

SECTION IV. TIME SCHEDULE AND AVAILABILITY OF CREDITS

(1) Each Federal reserve bank will publish a time schedule showing the time at which any item sent to it will be counted as reserve and become available for withdrawal or other use by the sending bank. For all checks received, the sending bank will be given immediate credit, or deferred credit, in accordance with such time schedule, and as provided below.

(2) For all such checks as are received for immediate credit in accordance with such time schedule, immediate credit, subject to final payment, will be given upon the books of the Federal reserve bank at full face value in the reserve account or clearing account upon day of receipt, and the proceeds will at once be counted as reserve and become available for withdrawal or other use by the sending bank.

(3) For all such checks as are received for deferred credit in accordance with such time schedule, deferred credit, subject to final payment, will be entered upon the books of the Federal reserve bank at full face value, but the proceeds will not be counted as reserve nor become available for withdrawal or other use by the sending bank until such time as may be specified in such time schedule,[3] at which time credit will be transferred from the deferred account to the reserve account or clearing account subject to final payment and will then be counted as reserve and become available for withdrawal or other use by the sending bank.

SECTION V. TERMS OF COLLECTION

The Federal Reserve Board hereby authorizes the Federal reserve banks to handle such checks subject to the following terms and conditions; and each member and nonmember clearing bank which sends checks to any Federal reserve bank for deposit or collection shall by such action be deemed (*a*) to authorize the Federal reserve banks to handle such checks subject to the following terms and conditions, (*b*) to warrant its own authority to give the Federal reserve banks such authority, and (*c*) to agree to indemnify any Federal reserve bank for any loss resulting from the failure of such sending bank to have such authority.

(1) A Federal reserve bank will act only as agent of the bank from which it receives such checks and will assume no liability except for its own negligence and its guaranty of prior indorsements.

(2) A Federal reserve bank may present such checks for payment or send such checks for collection direct to the bank on which they are drawn or at which they are payable, or in its discretion may forward them to another agent with authority to present them for payment or send them for collection direct to the bank on which they are drawn or at which they are payable.

(3) A Federal reserve bank may in its discretion and at its option, either directly or through an agent, accept either cash or bank drafts in payment of or in remittance for such checks and shall not be held liable for any loss resulting from the acceptance of bank drafts in lieu of cash, nor for the failure of the drawee bank or any agent to remit for such checks, nor for the nonpayment of any bank draft accepted

[3] For rules for computation of reserves and penalties for deficiencies in reserves, see Regulation D, Secs. III and IV, pp. 282–283.

in payment or as a remittance from the drawee bank or any agent.

(4) Checks received by a Federal reserve bank on its member or nonmember clearing banks will ordinarily be forwarded or presented direct to such banks, and such banks will be required to remit or pay therefor at par in cash or bank draft acceptable to the collecting Federal reserve bank, or at the option of such Federal reserve bank to authorize such Federal reserve bank to charge their reserve accounts or clearing accounts; provided, however, that any Federal reserve bank may reserve the right in its check-collection circular to charge such items to the reserve account or clearing account of any such bank at any time when in any particular case the Federal reserve bank deems it necessary to do so.

(5) Checks received by a Federal reserve bank payable in other districts will be forwarded for collection upon the terms and conditions herein provided to the Federal reserve bank of the district in which such checks are payable.

(6) The amount of any check for which payment in actually and finally collected funds is not received shall be charged back to the forwarding bank, regardless of whether or not the check itself can be returned.

SECTION VI. OTHER RULES AND REGULATIONS

Each Federal reserve bank shall also promulgate rules and regulations not inconsistent with the terms of the law or of this regulation, governing the details of its check clearing and collection operations. Such rules and regulations shall be set forth by the Federal reserve banks in their letters of instruction to their member and nonmember clearing banks and shall be binding upon any member or nonmember clearing bank which sends any check to such Federal reserve bank for collection or to any other Federal reserve bank for the account of such Federal reserve bank for collection.

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